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FINANCIAL PLANNERS AND INVESTMENT ADVISERS

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

FINANCIAL PLANNERS AND INVESTMENT ADVISERS AND WHAT CONSUMERS CAN EXPECT WHEN THEY CHOOSE TO SEEK PROFESSIONAL ADVICE TO PLAN THEIR FINANCIAL AFFAIRS

JULY 26, 1988

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FINANCIAL PLANNERS AND INVESTMENT ADVISERS

TUESDAY, JULY 26, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON CONSUMER AFFAIRS,
Washington, DC.

The subcommittee met at 10:10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd and Graham.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The Subcommittee on Consumer Affairs of the Committee on Banking, Housing, and Urban Affairs will come to order.

This morning we are gong to be conducting an oversight hearing on financial planners and investment advisers. We've got a distinguished group of panelists this morning who will be testifying.

Today's hearing is the third in a series of hearings by the subcommittee examining the ability of consumers to plan their financial affairs in an increasingly complicated world.

The first hearing highlighted some of the problems faced by consumers today:

We looked at the lack of time to plan their finances, particularly in families with only one parent and in families where both parents work; the lack of education on how to plan one's financial affairs—from elementary school all the way through college; and the enormous proliferation in nonstandardized investment products with noncomparable terms.

The second hearing, for those of you who participated, singled out one particularly important product that consumers were having trouble with—the home equity loan, citing the lack of advance disclosure and one-sided contract terms, including the ability of the lender to change any term at its discretion.

As a result of these first two hearings, the subcommittee pursued several pieces of legislation designed to help consumers figure out the best products for them—credit card cost disclosure, truth in savings, and home equity loan legislation. All three of these bills have passed both the U.S. Senate and the House and I would anticipate that action will be completed on them before the termination of the 100th Congress.

Today, the subcommittee turns its attention to the question of what consumers can expect when they choose to seek professional advice to plan their financial affairs.

To begin with, it is clear that the number of people offering professional planning advice has been increasing dramatically. Since 1981, the number of people registered with the SEC as investment advisers has more than tripled, from 4,580 to approximately 14,200. Moreover, as the SEC testimony points out, the assets they assist in managing has increased an estimated 900 percent, from around $440 billion to over $4.4 trillion.

These numbers tell us a lot about investment advisers, people who give advice about securities for compensation. What they tell little if anything about is the number of people who hold themselves out as "financial planners." When financial planners do not provide investment advice about securities but instead focus on insurance and real estate, they are not required—as most of you in this room know—to register as investment advisers and so there are no hard data as to the number of people who are providing financial planning advice. Informally, a number of groups have estimated the figure at upward of 200,000 in this particular category.

Not only are the number of professional money advisers increasing, so are the number of complaints, which shouldn't come as any great surprise, about fraudulent and incompetent advisers.

Given the number of people offering financing planning advice and the amount of money at risk for consumers, it is important to make sure that consumers are getting what they pay for. To this end, today's hearing will focus on the quality of the providers, abuses within the system and the adequacy of Federal and State regulation in this area.

In assessing the system and possible improvements, it will be important to keep in mind that we not only want to weed out dishonest and incompetent advisers, as all reliable and honest ones do, but we also want to provide the maximum number of competent professional advisers at the lowest possible cost for consumers. We will be seeking the advice of our excellent witnesses as to how we achieve these objectives or, perhaps, how we reach the best balance among competing objectives.

Many people have asked whether or not I am pointing specifically to a piece of legislation in this area. I am not at this point. I wouldn't exclude or eliminate that possibility, but I have no particular bill in mind at this particular juncture. I happen to believe that a lot in this area could be accomplished without legislation. Washington is only here to help you and has no intention of doing anything to complicate your lives is oftentimes a sentence taken with a great degree of suspicion, but I really am serious about that. I don't have a particular bill that I'm pursuing at this juncture.

So I'm looking forward today to our witnesses and to get that kind of solid advice as to how we ought to proceed, whether or not the problems that I have cited with these numbers are real, whether there really is not a problem out there or there is it's so small or infinitesimal it doesn't really warrant anything more than just bringing people's attention to the issue.

At any rate, I'd like to invite our first panel to join us this morning and if I mispronounce anyone's name I hope you will correct

me—Nancy Monseaux, a consumer from Baltimore, MD; Barbara Roper, financial planning specialist, Consumer Federation of America; and Ellyn Brown, Maryland Securities Commissioner, Baltimore, MD. I invite all three of you to join us here.

Just as a matter of housekeeping, if people would try and keep their comments down to somewhere between 5 and 7 minutes, if your statements run longer than that, I promise you they will be included in full in the hearing record, but so that we can move along this morning and get to the essence of the hearing.

Nancy Monseaux, you have your attorney with you?

Ms. MONSEAUX. Yes, I do.

Senator DODD. Would you like your attorney to sit with you?

Ms. MONSEAUX. Yes, I would.

Senator DODD. And we will begin in the order that I've introduced you. Nancy, we'll begin with you.

STATEMENT OF NANCY MONSEAUX, CONSUMER, BALTIMORE, MD, ACCOMPANIED BY W.P. GOODWIN, JR., ESQ.

Ms. MONSEAUX. Thank you. Mr. Chairman, my name is Nancy Monseaux and I live in Baltimore County, MD. I am appearing today at your request to discuss my experience with financial planners.

I am presently a plaintiff in a lawsuit against a financial planner which is now pending before the U.S. District Court in Maryland. I am accompanied today by my attorney, W.P. Goodwin, Jr., who has conducted an extensive investigation in connection with that suit.

CASE HISTORY

In 1986 I was 37 years old, divorced, and my home, which was my only substantial asset, was on the market. The profit which I stood to make from the sale of that home represented 14 years of hard work renovating houses in Baltimore. I had been employed by the State of Maryland in various administrative positions since 1970 and was earning about $29,000 a year. My plans were to sell my home and use the proceeds to travel a bit, change careers, and eventually to open my own business. Like many middle, working class Americans, I knew little or nothing about investment strategies or financial markets.

In February 1986, at the recommendation of a friend, I contacted Mr. Edward Astri to assist me in preparing my taxes. The Astri business appeared to be a small family operation with nicely appointed offices. There were diplomas and professional plaques and certificates displayed on the walls which identified Edward Astri and Robert Astri as members of financial planning associations.

Edward Astri, who appeared to be about 60 years old, explained that he had earned his fortune by working for the "big boys" and that now he was content helping inexperienced people like myself and helping his son get started in business. He gave me two business cards. One was for F&A Financial Planning Associates, which was also known as Fidelity & Associates, and which identified it as a business specializing in investments, financial planning, and estate planning. It also identified Edward Astri as both the company president and as a C.F.A. The other card was for AIMAS Securi-

ties—and that's A-I-M-A-S—and that stands for Astri Investment, Management & Securities Corp. The addresses on both cards were the same and as far as I could tell, they were one and the same business for all practical purposes, and that Edward Astri was in charge of both of them.

Based on his appearance and demeanor, what he had told me about his successful background, the certificates, the business card that said he was a certified financial analyst, and the fact that he seemed to know a lot more about finances than I did, I got the distinct impression that he was a competent financial planner who could be trusted to manage people's money, including my own.

For the next 5 months, after our initial meeting Edward Astri would phone me every couple of weeks to inquire how I was doing, and during those conversations I told him repeatedly that I had little knowledge or experience in investments and that I would have some money I would want to protect my nest egg while it created dividends that I could use while I established myself in a new career.

In June 1986, my house sold, I resigned my job, and 2 weeks before I was to leave on my travels Edward Astri phoned. During this conversation he admonished me for wanting to leave my money in a bank while I was away, insisting that I was missing the opportunity to get my money working for me. He convinced me to meet with him one evening before I left on my trip.

During that meeting in June 1986, I told him that I wanted to protect my money by splitting it up—perhaps by putting some of it into nontaxable government securities and the rest into a mutual fund which would create some dividends for me.

Edward Astri suggested two accounts—a Bullock account, which was very secure because I would own Government securities; and a Newbridge account which would produce better dividends. Mr. Astri didn't go into detail about either account and, frankly, I didn't know enough about this sort of thing to frame a reasonably intelligent question. He said nothing about how these accounts would work, nor what sorts of risks were involved. Relying on his advice that these accounts would satisfy my objectives, I opened the two accounts, which to the best of my knowledge at that time, were a Government securities account with Bullock and a mutual fund with Newbridge.

After I returned to the United States in September 1986, I moved to Bethesda, MD, and I phoned Mr. Astri. He told me at that time that my investments were doing very well, having earned nearly $3,000 during the 2 months I had been away. From time to time for the next several months, either Ed Astri or his secretary would phone me to tell me how well my accounts were doing and how I was earning money. These messages assured me that everything was fine in the accounts.

Early in 1987 I received a copy of a letter which Robert Astri had sent to Newbridge Securities in which he wrote about "necessary adjustments * * * to satisfy the margin notice" and "some temporary losses" in my account. The letter made little sense to me. No one had notified me of a problem in my account and I knew nothing about a "margin agreement."

I also received a tax form 1099 from Newbridge which showed approximately $116,000 in "gross proceeds." This only added to my confusion.

I called Edward Astri to make an appointment and was surprised when he told me that Robert Astri was handling my investment accounts. When I met with Robert Astri in February 1987, he informed me out of the blue that the $30,000 in my Newbridge account had been reduced to something in the neighborhood of $6,000.

I couldn't believe this was happening. I was literally in shock. I didn't know how I would survive in Washington, DC. on the $14,000 that I was earning as a travel agent. But I knew that even if I had tried real hard, I would have been hard pressed to squander $25,000 in 8 months and have nothing to show for it. To me, that was my life savings.

At that point, Mr. Goodwin and I began a long process to find out what had happened. I discovered that my Newbridge account wasn't a mutual fund at all. It was a fully discretionary brokerage account which was managed by AIMAS. Furthermore, AIMAS in reality was a registered securities brokerage owned by Robert Astri and his brother and sister.

A competent financial professional analyzed my monthly statements and told me that my account had actually been losing money each and every month that the Astris had authority over it. They had purchased $30,000 worth of Government securities all right, but they had used them as collateral to buy another $30,000 worth of stocks on margin. They had made more than 50 speculative trades. In other words, they had "churned" my account without my knowledge and certainly without my consent.

As a result of all the activity in my account, I had paid more than $9,000 to AIMAS as commissions and more than $2,500 to Newbridge as interest on the margin loan. That was more than $11,500 in commissions, fees, and interest on a $30,000 investment in just 8 months.

And it wasn't just my money that they squandered. Mr. Goodwin and I also discovered that many other ordinary people, working people, had trusted the Astris and had lost a big part if not all of their life savings in Newbridge accounts. All 29 of us who have brought suit are people of modest means. Some are retired steelworkers who entrusted the Astris with their lump-sum retirement benefits. Some are school teachers. One is a maintenance worker. One is a part-time cashier. Another is a young Catholic priest. Not a single one of us had ever speculated in securities markets before we met the Astris, and altogether we lost nearly a $½ million.

In many respects, I was lucky. Others were lured into investing in limited real estate partnerships or collectible coins. Those investments paid the Astris high commissions, but they tied up the victims' money for years or have obligated them to further payments on loans that they cannot now afford. By no stretch of the imagination were those investments or the discretionary, margined brokerage accounts suitable to our goals, which for all of us were, first and foremost, to protect our life savings.

Retrospectively, in my mind, Edward Astri was little more than a salesman of insurance policies, collectible coins, and other invest-

ments. He apparently made his money from commissions on those sales. To me, that is a direct conflict of interest, especially since he never disclosed to me or to my fellow victims that the money he earned depended not on what was best for us but on how much he could sell us.

Our investigation revealed that despite his holding himself out as a C.F.A.—or Chartered Financial Analyst—Edward Astri had been a hairdresser and a salesman for most of his life. In fact, not only had he never been awarded the C.F.A. charter, he had never been a candidate in the C.F.A. program.

On the other hand, he was a member of the International Association for Financial Planning, but his membership in that organization was terminated by its Ethics Committee on August 9, 1985 for disciplinary reasons. That action obviously had no effect whatsoever on his continuing to do business as a financial planner, or financial analyst.

AIMAS was registered by the Securities and Exchange Commission and by the National Association of Securities Dealers. Presumably the SEC or the NASD could have put AIMAS out of business, but that was no remedy, because AIMAS filed for bankruptcy in May 1987. A month earlier, in April 1987, Edward Astri and his wife filed for personal bankruptcy and F&A went out of business.

RECOMMENDATIONS

Mr. Chairman, I'm not a lawyer and I'm not a legislator, and I'm certainly not a financial expert, but I do have some recommendations.

First of all, there should be some agency which licenses and regulates financial planners and that has some teeth. Most of my fellow victims complained to the Maryland Securities Commission, and to the National Association of Securities Dealers, and to the Securities and Exchange Commission, but since AIMAS had already gone out of business, there wasn't much they could do.

Second, I'm very skeptical about self-regulation. Self-regulation protects the financial planners, not their customers.

Third, financial planners should lose their licenses if they make unsuitable recommendations, and they should be required to post a bond suitable to cover customer losses due to fraud.

Fourth, the amount of money charged by financial planners should be limited to a set fee. And they should be required to fully disclose in writing the commissions and fees they will charge, and the risks that are involved in a particular investment or investment strategy.

Fifth, the bankruptcy laws should be changed to make it difficult to use them as a means to avoid lawsuits for fraud.

Sixth, fraud in the sale of an investment should be made a Federal crime with stiff jail terms and fines.

Seventh, my fellow plaintiffs and I signed account applications that had a complete contract printed on the back. Most of us never knew we were signing a contract. To us, this was merely an account application. Included in that contract was an arbitration clause which, fortunately for us, excepted securities fraud cases. However, most people are not that fortunate and sign arbitration

clauses that require every dispute to be arbitrated. Since the Supreme Court's ruling last year in the *McMahon* case, they cannot go to court to get their money back and to recover punitive damages. I believe that Congress should go back to the old law, which said you cannot be required to arbitrate fraud cases. If stockbrokers and financial planners know they will face a jury of ordinary citizens who can assess punitive damages, they will be less inclined to play around with somebody else's money.

Thank you very much.

[The complete prepared statement of Ms. Monseaux follows:]

Senator DODD. Thank you very much. We'll come back with some questions in a minute. Let me turn to Mrs. Barbara Roper, a financial planning specialist at the Consumer Federation of America.

STATEMENT OF BARBARA ROPER, REPRESENTING THE CONSUMER FEDERATION OF AMERICA

Mrs. ROPER. Thank you. I'm here representing Consumer Federation of America, which is a coalition of 240 proconsumer groups around the country with a total membership of more than 50 million.

Thank you for inviting me to be here today to talk about financial planning abuses. It's a subject that we at CFA are increasingly concerned about. We're concerned because of the situation that currently exists in which anyone can call himself a financial planner. As a result, the term simply doesn't mean anything. And when consumers consult a financial planner, assuming that they are going to get competent, comprehensive, objective advice, too often they are wrong and they lose money.

THREE BASIC PROBLEMS

Basically, there are three problems. Because the field is so loosely regulated, it's wide open to con men who simply use financial planning as a cover to run their scams. It's also wide open to individuals who, though basically well-intentioned, are incompetent. Finally, there's a third problem in financial planning that arises out of the basic conflict in the way that most financial planners operate and that's the conflict between their dual roles as supposedly objective advisers and as self-interested product salesmen.

Financial planning is a particularly attractive cover for con men for the obvious reason that it provides a ready supply of victims who are expecting to spend money, who are going to reveal their intimate financial information, and who for the most part, lack the sophisticated knowledge to make their own financial judgments. The scams these con men run are infinite in variety, but for the most part they sell phony investments—whether they're limited partnerships or real estate investments or pension funds or precious metal investments. And when they run out of phony investments to sell, they can turn to embezzling their clients' funds to buy fancy homes and fancy cars for themselves or simply to gamble the money away on the commodities market.

Now clearly, what these so-called planners are doing is illegal, but in the vast majority of cases that does not do their victims any good. By the time the scam is discovered, the victims' money is long gone and their chances of recouping losses are negligible at best.

In 1986, we estimated that financial planning fraud was approximately a $500 million problem. Yesterday, the North American Securities Administrators Association came out with an excellent study describing some of these financial fraud cases. This study makes it clear that these cases are not rare, the problem is probably getting worse, and existing laws simply are not adequate to prevent these abuses from recurring.

Still, most planners aren't con men. Even so, consumers are losing money when their planner simply does not know enough to give good comprehensive advice but gives it anyway, or is more interested in inflating his commissions or earning sales incentives than in promoting the client's best interest.

The evidence is clear. The majority of planners spend more time on product sales than on planning. They earn most of their money from commissions, and they can be pretty hazy about disclosing that product sales tie-in to their planning operation.

EXAMPLES OF ABUSE

Let me give you a few examples of the kind of abuses we're talking about when we talk about self-interest. One easy example is that there are a lot of financial planning clients out there who bought mutual funds with an 8.5-percent front load when they could have bought no-load or low-load funds and invested the difference instead of paying it in commissions.

Similarly, many financial planners' clients have been encouraged to buy large amounts of universal life insurance, which carries a very high commission, instead of cheap term insurance, which has a low commission. And in some cases they have been encouraged to buy inadequate amounts of universal life because of that high commission instead of an adequate amount of term insurance.

And product sponsors have learned that they can sell more of their products when they offer incentives, whether they are credits toward purchases in a Sharper Image catalog or a week for two in Switzerland.

Now, people are not losing their life savings because of these abuses, usually, but they are losing money. And there is no reason why they should have to put up with it, particularly since we at CFA think there are some fairly simple steps that you can take that would plug some of these regulatory gaps.

These steps are outlined in detail in my written testimony so I'm not going to go into them in detail here, but I would like to just go over a few brief points.

We'd like you to start by issuing a blanket statement that all those who call themselves financial planners will be considered investment advisers and forced to register and be regulated as such. Once you get them registered, you have to inspect them—somebody, either the SEC or the States—within the first 6 months and then again periodically in the future. To do that you're going to have to increase funding for the SEC. They've done a great job with the money they've had in recent years, but their funding simply has not kept up with the growth.

We think one way you can solve this problem without further burdening the taxpayers is to increase the registration fee for investment advisers, particularly for the larger planning firms.

Classifying all planners as investment advisers will help clear up consumer confusion by ensuring that all those who call themselves financial planners are held to the same standards of conduct. And the standards of conduct in the Investment Adviser Act are good ones. There are a number of important consumer protections in that law. We think you can improve the act in small ways, particu-

larly by tightening disclosure requirements, by increasing some civil penalties, and most importantly by providing for private right of action under the statute.

If you allow consumers to sue for damages under the act when they can allege financial losses because of a violation of the act, in a sense you make it self-enforcing by creating a serious incentive for planners to uphold the high standards that are in the law.

Consumers deserve this protection. The financial world today is confusing enough and risky enough without allowing these abuses to go unchecked. The basic framework of laws is in place. All we'd like to see you do is fill in the gaps.

[The complete prepared statement of Mrs. Roper follows.)

STATEMENT OF NANCY MONSEAUX

BEFORE THE SUBCOMMITTEE
ON CONSUMER AFFAIRS
OF THE SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

July 26, 1988

Mr. Chairman, my name is Nancy Monseaux, and I live in Baltimore County, Maryland. I am appearing today at your request to discuss my experiences with financial planners.

I am presently a plaintiff in a lawsuit against a financial planner and others, which is now pending in the U.S. District Court for Maryland. I am accompanied today by my friend and attorney, W. P. Goodwin, Jr., who is in private practice here in Washington. He and the Baltimore law firm of Moore, Lipowitz and Thomas are representing me and 26 other persons in that case. Mr. Goodwin has conducted an extensive investigation in connection with that suit.

In 1986 I was 37 years old, divorced, and my home, which was my only substantial asset, was on the market. The profit which I stood to make on the sale of that home represented 14 years of hard work renovating older homes in Baltimore. I had been employed by the State of Maryland in various administrative positions since 1970. I was earning about $29,000 a year. My plans were to sell my home and use the proceeds to travel a bit, change careers, and eventually to open my own business. Like many middle, working class Americans, I knew little or nothing about investment strategies, financial markets, and those sorts of things.

In February 1986 I had sought some help deciphering our tax system. A friend suggested that I contact Edward Astri, an older man who had helped several other single, female acquaintances of mine handle their finances and tax returns. I made an appointment with him in order to begin the work on my taxes. The Astri business appeared to be a small family operation with nicely appointed offices in a suburban building outside of Baltimore. There were diplomas and professional plaques and certificates displayed on the walls which identified both Edward Astri and Robert Astri as members of financial planning associations.

Edward Astri, who appeared to be about sixty years old, explained that he had earned his fortune by working in investments with "the big boys" and now he was content helping inexperienced people like myself and helping his son, Robert Astri, get started in this business. He said that Robert Astri would prepare my taxes. He gave me two business cards. One was for F&A Financial Planning Associates, Inc., which was also known as Fidelity & Associates. The card identified F&A as a business specializing in investments, financial planning, and estate planning. It also identified Edward Astri both as the company president and as a "C.F.A." The other card was for AIMAS Securities -- that's A-I-M-A-S -- which stood for the Astri Investment, Management and Securities Corporation. The addresses on both cards were the same. As far as I could tell, they were one and the same business for all practical purposes, and Edward Astri was in charge of both.

Based on his appearance and demeanor, what he told me about his successful background, the certificates, the business cards which indicated that he was a certified financial analyst, and the fact that he seemed to know a lot more about finances that I did, I got the distinct impression that he was a competent financial planner who could be trusted to manage people's money, including my own.

For the next five months after our initial meeting, Edward Astri phoned me every couple of weeks to inquire how I was doing with my plans and life changes. During our first meeting and during those phone calls, I told him repeatedly about my lack of knowledge of and experience in investments. I told him several times that I wanted to protect my "untouchable nest egg" while it created dividends I could use as income while I re-established myself in a new career.

In June 1986, my house had sold, I had resigned my administrative position with the Maryland Department of Human Resources, and I was preparing to head off on my first real travel experience, content knowing that I had a substantial sum of money -- about $50,000 -- in the bank for the first time in my life.

Two weeks before I was to "make the break" and begin my travels, I told Edward Astri during one of his phone calls that my house had finally sold, and that I was busy preparing to depart on a two-month trip overseas. He admonished me for wanting to leave my money in the bank while I was away, insisting that I was missing the opportunity to get my money working for me. He convinced me to meet with him one evening before I would begin my travels.

During that meeting in June 1986, I told him that I wanted to protect my money by splitting it up -- perhaps putting some of it into non-taxable government securities and the rest into mutual funds which would create some dividends.

To my uninformed way of thinking, the non-taxable government securities would offset the taxable dividends that I would earn from the mutual fund.

Ed Astri suggested two accounts -- a Bullock account, which was very secure because I would own government securities; and a Newbridge account which would produce better dividends. Mr. Astri didn't go into detail about either account and, quite frankly, I didn't know enough about this sort of thing to frame a reasonably intelligent question. He said nothing about how these accounts would work, what sorts of risks were involved, or what recourse I would have if something went wrong. Relying on his advice that these were the best investments to meet my objectives, I wrote out the necessary checks to open the two accounts. To the best of my understanding, I had government securities in Bullock and a mutual fund in Newbridge.

After I returned to the U.S. in September 1986 and moved to Bethesda, Maryland, I phoned Edward Astri. He told me that my investments were doing very well, having earned nearly $3,000 during the two months I had been away. From time to time in the next few months, he or his secretary would phone me to tell me that I had earned some money that day. Naturally, these messages reassured me that everything was fine in my accounts.

Early in 1987 I received a copy of a letter which Robert Astri had sent to Newbridge Securities in which he wrote about "necessary adjustments...to satisfy the margin notice" and "some tempurary losses" in my account. This letter made little sense to me. No one had notified me of any problem in my account, and I knew nothing about a "margin account". As a matter of fact, I thought that the government had outlawed the purchase of stock on margin after the 1929 Stock Market Crash.

I also received a tax form 1099 from Newbridge Securities showing approximately $116,000 in "gross proceeds." That form only added to my confusion.

I called Edward Astri to make an appointment to meet with him and was totally surprised when he told me that I would have to see Robert Astri, who was handling my investment accounts. When we met in February 1987, Robert Astri informed me, out of the blue, that the $30,000 in my Newbridge account had been reduced to something in the neighborhood of $6,000.

I couldn't believe this was happening. I was literally in shock. I didn't know how I would survive in Washington, D.C., on the $14,000 a year I was earning in my "new career" as a travel agent. But I knew that even if I had tried real hard, I would have been pressed to squander $25,000

in eight months and have nothing to show for it. To me, that $25,000 was my life savings, the foundation of my future.

Mr. Goodwin and I then began a long process to find out what had happened. I discovered that my Newbridge account wasn't a mutual fund at all; it was a fully discretionary brokerage account which was managed by AIMAS Securities. AIMAS was not a financial planning firm at all but a registered securities brokerage outfit owned by Robert Astri and his brother and sister.

A competent financial professional analyzed my monthly statements and told me that my account had been losing money each and every month that the Astris had authority over it. They had purchased $30,000 worth of government securities alright, but they used them as collateral to buy another $30,000 worth of stocks on margin. They had made more than 50 speculative trades with those stocks. In other words, my account had been "churned" without my knowledge and certainly without my consent.

As a result of all the activity in my account, I had paid more than $9,000 to AIMAS as commissions and more than $2,500 to Newbridge as interest on the margin loan. That was more than $11,500 in commissions, fees, and interest on a $30,000 investment in just eight months.

It wasn't just my money these guys squandered. Mr. Goodwin and I also discovered that many other ordinary people, working people, had also trusted the Astris and had lost a big part if not all of their life savings in Newbridge accounts. All 29 of us who have brought suit are people of modest means. Some are retired steel workers who entrusted the Astris with their lump-sum retirement benefits. Some are school teachers. One is a maintenance worker. One is a part-time cashier. Another is a young Catholic priest. Only two of us have had any experience running a business: a young husband and wife who own a small firm which teaches gymnastics to children. Not a single one of us had ever speculated in securities markets before we met the Astris.

In many respects, I was lucky. Others were lured into investing in limited real estate partnerships or collectible coins. Those investments paid the Astris high commissions, but they have tied up the victims' money for years or have obligated them to make further payments on loans that they cannot now afford. By no stretch of the imagination were those investments or the discretionary, margined brokerage accounts suitable to our goals, which for all of us was -- first and foremost -- to protect our life savings.

There were a few suitable investments recommended to us by Edward Astri. My Bullock government securities mutual fund was one of them. But he never told me that I would pay a

commission on those shares, or that I could invest in other comparable funds which did not charge a commission.

Restrospectively, in my mind Edward Astri was little more than a salesman of insurance policies, collectible coins, and other investments. He apparently made his money from commissions on those sales. To me, that is a direct conflict of interest, especially since he never disclosed to me or to most of my fellow victims that the amount he made depended not on what was best for us but on how much he could sell to us.

Our investigation also revealed that despite his holding himself out as a C.F.A. -- or Chartered Financial Analyst -- Edward Astri had been a hairdresser and salesman for most his life. In fact, not only had he never been awarded the C.F.A. charter, he never even had been a candidate in the C.F.A. program.

On the other hand, he was a member of the International Association for Financial Planning, but his membership in that organization was terminated by its Ethics Committee on August 9, 1985, for disciplinary reasons. That action obviously had no effect whatsoever on his continuing to do business as a financial planner, or financial analyst, or whatever you want to call it.

AIMAS was registered by the Securities and Exchange Commission and by the National Association of Securities Dealers. Presumably the SEC or the NASD could have put AIMAS out of business. But that was no remedy, for AIMAS filed for bankruptcy in May 1987. A month earlier, in April 1987, Edward Astri and his wife filed for personal bankruptcy, and FSA went out of business. Because they are in bankruptcy, we were not able to sue Edward Astri and AIMAS in our joint case.

Believe me, the costs of bringing a lawsuit are prohibitive to most people who have been defrauded. Individually, neither I nor my fellow plaintiffs could have pursued this lawsuit on our own. I can also assure you from my own experience that there are few attorneys who will bring such a case against a small firm on strictly a contingency basis.

Mr. Chairman, I am not a lawyer or legislator. I especially am not an expert on the financial industry. But I do know enough about public administration to make a few suggestions about how you might protect unsophisticated investors from unqualified or unscrupulous financial planners.

First, there should be some agency at either the state or federal level to license and regulate financial planners, just as stock brokers are now registered and regulated by the SEC. That agency or agencies should have some real teeth.

I and most of my fellow victims complained to the Maryland Securities Commission, the NASD and the SEC, but since AIMAS had already gone out of business, there is not much they could do. And they don't even have jurisdiction over Edward Astri as a financial planner.

Second, I personally am skeptical about so-called self-regulation. I believe that some governmental agency must oversee these regulators like the SEC now oversees the NASD.

Third, financial plannners should lose their licenses if they make unsuitable recommendations, and they should be made to repay any customers who lose money because of those unsuitable recommendations. Furthermore, financial planners should be required to post a bond sufficient to cover their customers' losses which have resulted from their fraud or unsuitable recommendations.

Fourth, the amount of money charged by financial planners should be limited to a set fee. In other words, they should stand to gain no more by selling you collectible coins than they would shares in a mutual fund. Also, they should not earn commissions on investments made with money borrowed from them, their associates, or the firms they sell for. At a minimum, they should be required to disclose in writing the commissions and fees they will charge and the risks involved in a particular investment or investment strategy.

Fifth, the bankruptcy laws should be changed to make it difficult to use them as a means to avoid lawsuits for fraud. Rather than staying a civil fraud suit because someone has filed for bankruptcy, maybe it ought to work the other way around.

Sixth, fraud in the sale of any investment, including the churning of customers' accounts, should be made a federal crime subject to stiff jail terms and fines.

Seventh, my fellow plaintiffs and I signed account applications that had a complete contract printed on the back. Most of us never knew we were signing a contract; to us, this was merely an account application. Included in that contract was an arbitration clause which, fortunately for us, excepted securities fraud cases. Most people are less fortunate and sign arbitration clauses that require every dispute to be arbitrated. Since the Supreme Court's ruling last year in the McMahon case, they cannot go to court to get their money back and to recover punitive damages. I believe that Congress should go back to the old law, which said you cannot be required to arbitrate fraud cases. If stockbrokers and financial planners know they will face a jury of ordinary citizens who can assess punitive damages, they will be less inclined to play around with other peoples' money.

Thank you very much.

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Consumer Federation of America

Testimony of
BARBARA ROPER
CONSUMER FEDERATION OF AMERICA

Before the
CONSUMER AFFAIRS SUBCOMMITTEE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
U.S. SENATE

on
FINANCIAL PLANNING ABUSES
July 26, 1988

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

Mr. Chairman and members of the Committee, my name is Barbara Roper. I represent the Consumer Federation of America, a coalition of 240 pro-consumer groups with approximately 50 million members.

Several years ago, we began to hear from our members that they were concerned about the abuses being perpetrated in the name of financial planning. Most of the information then available about financial planning abuses was anecdotal. No one seemed to know how common abuses were or even how many people there were operating under the name of financial planner, legitimately or otherwise. CFA decided to conduct a study in which we would examine industry practices in order to develop a comprehensive picture of the industry, including the problems, their causes, and some possible solutions.

As a result of that study, we concluded that the anecdotes of abuse presented in the media and by individual victims were part of a larger pattern of abuse that included not only fraud, but also basic conflicts in the way financial planning is practiced by the majority of planners. Furthermore, it was clear that the lack of adequate regulation was allowing such abuses to continue virtually unchecked.

As a part of our study, we analyzed the yellow pages for 20 of the nation's largest cities and came up with an estimate that there were at least 250,000 individuals calling themselves financial planners in 1986, and possibly as many as 400,000. Because there is no legal restriction on use of the term, we included in our estimate all those who called themselves financial planners and responded to requests for personal financial planning advice.

Ours is necessarily a loose estimate, since a lack of specific information necessitated our building some assumptions into the analysis we performed. But there is evidence to indicate that it is fairly reasonable. For instance, in California alone the state securities administrator estimates there are 60,000 individuals holding themselves out as financial planners. We can only guess that those who claim there are only 50,000 planners in the entire nation are using a restrictive definition for which there is no legal basis.

Within that total planner population, the differences in the services offered in the name of financial planning can be staggering, not just between those who are frauds and those who are legitimate, but also between those who are providing some form of valid service to the consumer. While this makes it difficult, if not impossible, to develop an exact definition of financial planning, we believe it can, nonetheless, be fairly simple to define certain practices that do not qualify and to set some standards and guidelines for the rest. Not only do we

ADEQUACY OF CURRENT REGULATORY EFFORTS

It is popular to say that financial planners are completely unregulated. While it is true that they are not regulated specifically as planners, almost all of the functions they perform are subject to some regulatory oversight. When they sell securities or insurance, they are subject to regulations governing those sales. And even their advisory function is covered by the investment advisor laws at the federal and state levels.

So, nearly all of the major financial planning abuses are already covered by existing laws. In some cases, confusion arises over the applicability of those laws to financial planners. In other cases, inadequate enforcement is the problem. Particularly for the victims of fraud, legal protection almost always comes too late. Their savings are already gone, and only rarely do the victims recover more than a small portion of their losses. If the consumer is to be protected, a better job must be done to detect and deter such abuses before they are established.

CFA'S FEDERAL REGULATORY PROPOSALS

We believe the best way to accomplish that goal is to strengthen the existing regulatory structures at the federal and state levels. By taking a few, relatively inexpensive steps, Congress and the SEC can stop up the holes in the current structure and provide for improved deterrence before abuses occur.

We believe the obvious place to start is clarifying that all financial planners are subject to investment adviser laws at the federal and state levels. The easiest way to accomplish this at the federal level is probably through a policy statement to that effect by the SEC. Should the SEC be unwilling to adopt such a policy on its own, Congress should amend the Investment Advisers Act of 1940 to state that all those who hold themselves out as financial planners will be regulated as investment advisers.

The investment adviser laws already address the primary areas of concern in financial planning: conflicts of interest, fraud, suitability of advice, and duty to obtain best execution for clients' securities transactions. Most importantly, the law appropriately defines the relationship to the client as entailing a fiduciary duty.

Use of the term financial planner -- by implying the provision of comprehensive, objective financial advice -- implies that the investment adviser definition is met. Although not all those who currently call themselves planners do fit the definition, our survey of 30 Washington, D.C. planners, as well as similar information from other sources, leads us to conclude that the majority do fit that definition. Furthermore, those "planners" who do not fit the definition are in most cases using

the term as a front for efforts to sell specific financial services and products. We consider this a deceptive practice that should be stopped.

One way to insure that those who should register do so would be to increase civil penalties for failure to register so that those penalties provide a serious incentive for compliance. Publicity of increased penalties could be expected to stimulate more registrations at little or no cost to the SEC.

Deterrence under the Investment Advisers Act is based primarily on regular, thorough SEC inspections of registered firms. The SEC is apparently unable to state how often such inspections are performed, but that agency does acknowledge that, in recent years, there have been more new registrations each year than there have been inspections. Members of the financial planning industry estimate that inspections often take place no more than once a decade. The SEC has appropriately focused its inspection efforts on new and risky planners, those who disclose on their applications that they take custody or discretion of client funds or who have a prior record of legal violations.

Nonetheless, the current inspection program is clearly too limited to provide adequate deterrence. According to the SEC, the number of inspections per staff year has nearly tripled since 1980. If, as the SEC claims, this is the result of improved productivity, we applaud the SEC for its efficiency. Another possible interpretation, however, is that too small a staff is being asked to do too much work. This is born out by other statistics. Between 1975 and 1985, during which period the SEC staff declined slightly in size, the number of registered broker/dealers and the number of registered investment advisers both more than tripled, as did the number of complaints from the public. Meanwhile, the commission brought significantly fewer cases.

We urge Congress to fund the much needed increased staffing for inspections. To accomplish this goal, we would support an increase in investment adviser registration fees. In order to avoid placing too heavy a burden on the many small financial planning operations, fees could be adjusted to reflect either the amount of assets under management or the number of investment adviser employees in a firm. Thus, those firms that pose the greatest financial burden to inspect would carry a proportionate share of that burden.

Another important element of the investment advisers law is its heavy reliance on disclosure to provide consumer protections. The findings of the SEC report call into quetion the degree of protection currently being provided. Special SEC inspections conducted for the report found deficiencies in this area to be common. Not only was the quality of disclosure revealed to be

highly uneven, but also the relationship between planning and sales was often not clearly revealed.

We would support efforts to improve the quality and extent of disclosure. One step that has been suggested, which we endorse, is to include Part 1 of Form ADV in the brochure rule, as well as Part II. This would give consumers access to the same material in selecting a planner that the SEC uses to evaluate applications. Also, the form disclosure can take should be limited, so that disclosure statements cannot be hidden in the small print of slick promotional brochures.

Another method of insuring clear, complete disclosure is to have the SEC reject applications on the grounds of unclear or contradictory disclosure statements and require that disclosure be clarified before the application is granted. And, as with civil penalties for non-registration, penalties for non-disclosure could also be raised to provide a serious incentive for compliance.

Disclosure is just one of several areas -- including provisions on conflicts of interest, the fiduciary duty, best execution of transactions, and suitability of advice -- where strong enforcement is essential if the law is to have the effect Congress obviously intended. Again, SEC resources in this area appear to be inadequate, and Congress should remedy that through the appropriations process.

We recognize, however, that there is a limit to the resources Congress can allocate. One way to improve deterrence without allocating additional resources is to amend the Investment Advisers Act to provide for private right of action under the Act for clients who could allege financial damage stemming from violations of the Act by advisers. The SEC itself proposed such an amendment in 1976. Given the tremendous growth in the industry since then and the growth in accompanying abuses, the amendment is even more necessary today.

Some within the industry have used the inadequacy of SEC resources as an argument in favor of creating a self-regulatory organization for financial planners. We believe such a step would be entirely inappropriate and a serious mistake. Serious questions have recently been raised about the effectiveness of existing self-regulatory organizations in the securities industry, where, because of the transactional nature of the relationship, members of the industry have a vested interest in protecting themselves from each other.

In financial planning, it is only the clients who need protection. Obviously the planners are not the ones to provide that protection. While they may have some interest in driving out con men who blacken their image, their self-interest does not

dictate wiping out the widespread abuses related to misrepresentation and the inherent conflict between their roles as objective advisers and as sales people. The SEC tells us that investment adviser inspections are "subjective" in nature. Simple common sense dictates that the consumer interest is not served by having these subjective decisions made by those either in the industry or captive of the industry being regulated.

The NASD has offered to serve as an SRO for its members who are also investment advisers. This proposal has additional problems with it beyond those inherent in any SRO proposal for investment advisers. The NASD is oriented toward product delivery, making it particularly inappropriate as a guardian against conflicts between advisory and sales functions. Also, the NASD would cover only a part of the financial planning community. This would add to, not alleviate, the current regulatory confusion. Also, the quality of NASD inspections within its current jurisdiction have been called into question, particularly its inspections of branch offices. Since investment advisers operate largely at the branch level, this would be a serious deficiency.

The results of the NASD pilot project increase rather than allay our fears. Overall, NASD inspectors found four times fewer deficiencies than did SEC inspectors. The SEC found seven times as many deficiencies related to conflict of interest. And the NASD missed entirely deficiencies serious enough to call for enforcement referrals by the SEC.

Finally, no scheme to improve the regulation of financial planners can be complete without improving regulation in the areas of product sales, since this is where serious abuses most commonly occur. Congress needs to take a close look at the adequacy of the self-regulatory organizations in the securities industry and the quality of SEC oversight of these organizations. In particular, the industry arbitration system is in serious need of reform to ensure that aggrieved investors have adequate means of redress. This is particularly important in light of the Supreme Court decision upholding the right of broker/dealers to include binding arbitration clauses in their contracts. The insurance industry also needs to be subject to closer scrutiny, and we support federal legislation to repeal portions of the McCarran-Ferguson Act as well as initiatives at the state level to improve state regulation. We would also encourage Congress to examine the adequacy of existing protections in the area of limited partnerships, in which millions of dollars have been lost by clients of financial planners, among others, who were given inadequate warnings about the risks associated with such investments.

There are additional steps that must be taken at the state level to improve the regulatory system, particularly passage in

Senator DODD. Thank you very much for your testimony.
Ms. Brown.

STATEMENT OF ELLYN L. BROWN, SECURITIES COMMISSIONER, STATE OF MARYLAND

Ms. BROWN. Thank you, Mr. Chairman. Thank you for inviting me here today.

My name is Ellyn Brown. I'm the Securities Commissioner for the State of Maryland. You have my written testimony so I'd like to speak more informally today.

I come from a State where, unfortunately, Ivan Boesky could be a financial planner should he choose to do so, along with Ed Astri, as Nancy Monseaux has told you.

Maryland has no statute that sets qualifications or requires registration of either financial planners or investment advisers, nor does Maryland require disclosure to clients of information about planners' or advisers' qualifications or the basis for their compensation.

Attorney General J. Joseph Curran, Jr. and I hope that this will change in the 1989 session of the Maryland General Assembly. We have drafted departmental legislation and we will work hard to demonstrate its need to our legislature. That proposed by the way, would make investment advisers and financial planners definitionally equivalent and would do very much of what Ms. Roper spoke about in her testimony.

Because no registration statute exists in Maryland, we really have no idea of the actual numbers of financial planners in our State. We believe it's safe to assume that the numbers are significant and well exceed the 115 investment advisory firms in Maryland that are registered with the SEC.

We are fortunate to be a wealthy State, based on per capita income, and we know that our population's available income attracts a number of stock broker licensing applications and registrations of securities sales that is in fact disproportionate to our actual population. Green pastures are attractive, and I must assume that we have our share or more than our share of financial planners in the State of Maryland.

The profession has grown up in Maryland and elsewhere from the underlying professions of accounting, insurance, securities sales, real estate sales, and law. It's grown up to meet a real consumer need that can't be minimized or ignored. Our financial marketplace is complex, and in the face of these complexities people want to turn to experts to help them analyze, plan for, and maximize their resources and their abilities to cope with children's education, retirement planning, and other important family expenses and goals.

The instinct to look for expert help is understandable and, in fact, it's prudent. In most cases, confidence can be placed in a reputable financial planner. In some cases, however, in Maryland and elsewhere, this confidence has been sorely abused to the tune of millions of dollars lost. Victims in Maryland have included Ms. Monseaux, college professors, teachers, and other professionals, and retired steel workers who withdrew their pension funds to place

money with a financial planner and are now, in their "golden years," working minimum wage jobs to keep their homes.

In several cases we have been fortunate that the Maryland Division of Securities has been able to act against financial planners because of our jurisdiction under the Maryland Securities Act to move against those who sell unregistered securities or who sell securities without a license. In other instances, however, in "straight" financial planning cases, we have no statutory basis to act. In almost all cases, unfortunately, we find that investors' money is gone and that civil recovery suits will accomplish very little.

Joe Curran, our Attorney General, and I hope that the Maryland General Assembly will be persuaded in its coming term to pass financial planning legislation. We hope also that implementation of a nationally centralized computerized registration system for financial planners will be available. This would cut our program costs considerably and promote effective communication among States about problem planners and with regard to enforcement issues.

Once our enforcement tools are in place, however, we think that our job has just begun. As participants in the financial marketplace, whether as industry representatives or as government regulators, our obligation to consumer education is paramount. I know this committee has considered that question and I can't overemphasize what I believe to be its importance. I'm not talking about pamphlets from Pueblo, CO, but a kind of a financial literacy education beginning in the schools.

We must also work hard to ensure that adequate resources are available to enforce financial planning laws. Investigations and prosecutions, as I can well tell you, are extremely expensive and time consuming. Lots of staff is required. We believe, though, that these kinds of investigations and prosecutions can remove those from the arena who will otherwise find future victims, and can also act as a deterrent. Also, good cases make good press, which makes for increased consumer awareness.

I believe that most financial planners intend to be reputable, honest, and in business for the long run. We need a partnership of industry and State and Federal government to stop those few who will otherwise victimize many. Thank you very much.

[The complete prepared statement of Ms. Brown follows.]

WRITTEN TESTIMONY OF
ELLYN L. BROWN,
SECURITIES COMMISSIONER FOR THE STATE OF MARYLAND,
BEFORE THE
CONSUMER AFFAIRS SUBCOMMITTEE
OF THE
UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OVERSIGHT HEARINGS ON FINANCIAL PLANNERS
TUESDAY, JULY 26, 1988

I have been asked to speak to you today about my experiences as the Securities Commissioner of a State that does not regulate financial planners as such. The State of Maryland does not now register or otherwise screen financial planners; thus, anyone, no matter how qualified or unqualified, may hold himself out as offering such services. As the financial planning profession has grown up out of the seminal financial and legal services professions, the ranks of those denominating themselves "financial planners" have burgeoned, as any survey of metropolitan yellow pages will reveal.

Attorney General Joseph Curran and I believe that Maryland's lack of a registration law may increase the likelihood of misuse of client funds, and we are hopeful that the Maryland General Assembly will take action in its upcoming term to regulate financial planning activities in our State. We have a new administration that has now had the opportunity to evaluate such legislation, and we plan to work hard in the next session to demonstrate the need for financial planning regulation to our legislature.

I must tell you, however, that we are not so naive as to believe that regulation of financial planners can ever ensure against all fraud and abuse. What is needed to curtail and control the problems in any segment of the financial services industry is, first, informed and inquisitive consumers, and, second, adequate enforcement capability of industry regulators.

In the course of the year that I have served as Securities Commissioner of Maryland, several major financial planning cases have come into our office. Fortunately - although rather unfortunately for the victims - a few of these cases have involved the sale of unregistered securities, or sales of securities by persons not licensed to sell securities. As such, the Securities Division has had jurisdiction per force of the Maryland Securities Act to seek civil sanctions. Our statute does not, however, permit us to seek recission and restitution on behalf of investors, i.e., there is no parens patria provision in Maryland law.

In one case, where we estimate that more than 1.5 million dollars in client funds were misappropriated, we were able to obtain a permanent injunction barring the defendant from ever again working in the securities or investment advisory industries, and secured the appointment of a court-appointed receiver to retrieve the few assets that may remain available to satisfy investors' losses. In another case, which is still under investigation by the Division while the targets are in bankruptcy, we believe that millions of dollars of funds were

believe this to be possible, we view it as essential to the protection of the millions of American consumers who consult these planners without being aware of what service they can expect, what dangers they are exposed to, or how to differentiate between a legitimate planner and one who either lacks the ability or the intention to provide them with sound financial advice.

Since we released our study in July 1987, the Securities and Exchange Commission has completed its own study of those financial planners who are registered with the SEC as investment advisers. We find that this study goes a long way toward supporting our own findings and, particularly in the area of planner self-dealing, strengthens our conclusions about the extent and seriousness of abuse.

THREE TYPES OF ABUSE

For the purposes of our study, we divided financial planning abuse into three categories: fraud, self-interest, and incompetence. In the category of fraud, we included serious violations of securities law, as well as other criminal and civil statutes, where the purpose is to cheat or deceive the client. By self-interest we mean the rendering of advice based primarily on the commission or sales incentives to be earned from products sold, rather than on the client's best interest. In the category of incompetence, we refer to those abuses that arise, not primarily from a desire to deceive or illegitimately profit by the advice, but rather from a lack of the comprehensive knowledge necessary to render adequate, valid advice.

Fraud -- A great deal of valuable information about financial planning fraud has been reported in the news media. Most of the reports have, quite naturally, focused on the most dramatic cases of fraud, since these are the cases that grab the headlines. In order to expand on the information available in the media, CFA conducted a survey of state securities administrators to determine the range of abuses they had uncovered and, as far as possible, the number of victims and dollar amounts involved. Based on that survey, we concluded that financial planning fraud was at least a $500 million problem in 1986. Furthermore, we determined that, while fraud is a serious problem among financial planners, it is a problem associated almost entirely with con men operating on the fringes of this legitimate profession.

Certain types of fraudulent activities were reported repeatedly. For example, securities administrators in six different states reported cases in which individuals had set themselves up as financial planners in order to attract clients (and gain access to information on the clients' financial status); had then written seemingly legitimate plans for those clients, often charging a fee for the plan; and finally had

offered to take discretion of the clients' funds in order to implement the plan. Instead, these so-called planners either lost the money through speculation or embezzled it.

Another common form of fraud reported by state securities administrators is the sale of unregistered securities, often in the form of abusive tax shelters. For example, a group of California financial planners encouraged their clients to invest in what turned out to be a phoney factoring operation. The promoter of the scheme proposed to purchase accounts receivable at a discount using the investors' money, making a profit for the investors when the accounts were paid at their full value. In fact, he didn't purchase any accounts receivable, issued worthless certificates, and pocketed approximately $22 million in investors' money. Even if the scheme had been legitimate, the financial planners should have known the investment had to be registered as a security, which it wasn't. But the planners, who were needed as witnesses against the promoter, were not prosecuted.

These are just two examples of fairly typical types of fraud, of which there are myriad variations on the theme. One thing almost all forms of fraud have in common is that it is only discovered after the victims' money is gone.

As it is currently regulated, financial planning is an open invitation to con men. Where else can they set up with no entry requirements, almost no direct supervision, and have their victims lining up to give them access to their most intimate financial data? Based on a survey of state securities administrators, we estimated that financial planning fraud was at least a $500 million problem in 1986.

Self-interest -- Unlike fraud, self-interest is a problem that is inherent in the way the majority of planners do business. Planners promise, and clients expect, objective advice. But most planners rely on commissions from sale of financial products for the majority of their income. They sell those products -- such as insurance, mutual funds, annuities, and limited partnerships -- to implement their plans. It is up to the individual planner how he or she handles this basic conflict. Many planners may be able to preserve their objectivity, and some avoid the problem entirely by refusing to sell products. But there is convincing evidence that all too often planning is sales-directed.

According to the SEC study, most planning firms spend more time on product sales than on planning and earn more money from sales commissions than from planning fees. Furthermore, according to the SEC study, many planners do not clearly inform clients of the product sales tie-in to the planning activity.

When Consumer Reports examined the financial planning industry in January 1986, they found that many planners have "hidden agendas" to sell products. In analyzing the planning services offered by seven nationwide firms, Consumer Reports found that the plans almost always reflected the primary business of the company designing the plan. For example:

• The planner from Aetna Life & Casualty Co. recommended a number of insurance products, including $265,000 worth of universal life insurance at an annual cost of $2,800 (which the couple did not have) rather than a comparable amount of term insurance at an annual cost of less than $400. Universal insurance generally pays a much higher commission than does term insurance.

• In the plan provided by IDS/American Express, seven of the eight recommendations specified IDS products, despite disclaimers that the couple was under no obligation to buy IDS products. Among the recommendations, $524,355 worth of universal life at an annual cost of $2,400. IDS did say the couple could buy the same amount of term insurance for only $1,380 a year, but did not mention that term insurance can be purchased from other providers for considerably less. When questioned later by the reporter, the IDS agent acknowledged that he was under considerable pressure from the company to sell the products recommended.

• Merrill Lynch recommended the couple put 40 percent of its assets into stocks, despite the couple's stated low tolerance for risk; and, without explaining how the couple would afford it or what type to buy, Merrill Lynch recommended nearly $1 million in life insurance.

• As for the plan provided by Prudential Bache, Consumer Reports had this to say: "The chief mission of the Prudential-Bache account executive seemed to be selling Prudential-Bache investment products."

Many conscientious planners also complain that their less scrupulous colleagues recommend almost exclusively products with high commissions, such as mutual funds with an 8.5 percent front load, annuities, or limited partnerships. The SEC study provided evidence to bear this out. According to that study, most planning clients have conservative objectives (such as capital growth with safety of principal or capital growth with income), but highly speculative, risky and illiquid real estate limited partnerships are major income earners for many planners.

Commissions are not the only source of trouble. Planners are also encouraged to give self-interested advice by sales incentives offered by product sponsors, incentives ranging from a free Thanksgiving turkey to a Porsche 944 Turbo (offered to the winner of a national sales contest). One Washington area planner

said he receives such promotional materials almost daily, including offers of credits toward purchases from the Sharper Image catalog or a week for two in Switzerland. In November 1986, The Wall Street Journal reported that product sponsors say sales go up when a contest is offered and often fall when one is not.

Self-interest is usually much more difficult than fraud for clients to detect. Rarely do clients lose all their money because of self-interested advice. Instead, they waste money paying commissions that could have been invested, or they end up in investments that are not as well suited to their needs or risk tolerance as other lower-commission investments might be.

Incompetence -- To fulfill its promises of comprehensive analysis, financial planning requires a wide-ranging financial expertise, including, among other things, a thorough knowledge of taxes, life and health insurance, stocks and bonds, trust funds, pensions, real estate, limited partnerships, and all other securities. It would be virtually impossible for a single individual to acquire true expertise in all these areas.

Some planners get around that limitation by forming associations with other professionals. Others simply refer clients to experts when appropriate. Too often, however, planners try to perform these functions themselves; they tailor their advice to avoid those areas where they are not expert; or they simply offer the same, pre-programmed advice to all their clients, regardless of differences in needs. A former insurance salesman now calling himself a planner, for example, may give almost the identical advice to that which he would have given when his role was simply to sell insurance. Often, the advice that results is incomplete and/or inappropriate.

One way for planners to gain more comprehensive knowledge is by completing one of the voluntary education programs, the best known being the Certified Financial Planner and the Chartered Financial Consultant programs. Although skyrocketing enrollments in these programs indicate that many planners are following this route, only about a fourth of all planners have completed such a program. And the completion of such a program, though a good indicator, is not a guarantee of competence.

Abuses related to incompetence, like those associated with self-interest, are difficult to quantify. In the course of our study, we estimated that these two categories combined account for at least $500 million a year in misinvestments. Since releasing that figure, we have been told by several members of the industry that, if anything, our estimate is too low.

all 50 states of the North American Securities Administrators Association model amendments to the state investment adviser laws. States have an important role to play in regulation of planners, many of whom operate in small offices within a restricted geographic region. In recent years, the SEC has increasingly cooperated with the states in its oversight of the financial planning industry. We support this effort and hope it will continue to develop in those states that are actively and aggressively involved in financial planning regulation.

In particular, we would encourage SEC participation in the development of a national computerized registry of financial planning firms and their representative planners. Such a registry should include a record of any enforcement actions taken at the federal or state level against a firm or individual, so that such information is readily available to the SEC and to states for use in evaluating applications for registration.

Taken together, we believe these steps would provide a comprehensive, coherent system of regulating financial planners and much needed consumer protections. With billions of consumers' hard earned dollars at stake, the need for action is clear.

Senator DODD. Thank you very much. I thank all three of you. I've been joined by my colleague, Bob Graham, from Florida.

Let me just ask a few questions if I can and, Bob, Miss Monseaux is sitting with her attorney and she has a pending case in court so we want to be careful about some of our questions that we don't in any way create any difficulties.

Let me ask, Miss Monseaux, what your educational background is?

Ms. MONSEAUX. I have a master's degree in public administration.

Senator DODD. The reason I asked that is that's a bit more than some of the people you cited of the other 28 who are litigants in this matter—I presume many of them do not have that kind of level of education.

Ms. MONSEAUX. That's true. Many of them are high school graduates.

Senator DODD. Were you familiar with what a margin account was?

Ms. MONSEAUX. No. As a matter of fact, it was my understanding that margin accounts were outlawed by the Government at the point of the 1929 stock market crash, so I thought there was no such thing as a margin account these days.

Senator DODD. Who are you suing now?

Ms. MONSEAUX. I am suing F&A, Fidelity & Associates. I'm suing Robert Astri, his brother, and sister. I'm suing Newbridge Securities Corp., everyone that was involved in any way in the organizations. There were several corporations involved.

Senator DODD. And the fact that they've taken the bankruptcy laws, that doesn't affect it?

Ms. MONSEAUX. Well, one corporation and one individual have filed in bankruptcy, but all of the other corporations of which I believe there were three or four and the other members of the Asti family have not gone into bankruptcy. I'm also suing a broker who was employed by the firm and was working on the accounts.

Senator DODD. And did you ask Mr. Astri at all about his background? You looked at the plaques on the wall, but did you get into any at least preliminary conversations with him?

Ms. MONSEAUX. Yes. In my initial meeting and then several times after that we had talked about his background and he presented himself as though he had been in investments and investment planning all of his life and had made considerable money doing that for both himself and his clients.

Senator DODD. He didn't tell you that the Ethics Committee of the International Association for Financial Planners had removed him from the list?

Ms. MONSEAUX. No, he didn't mention that.

Senator DODD. Was that one of the plaques on the wall?

Ms. MONSEAUX. I must say at the moment I don't recall.

Senator DODD. Well, how did you know he was a member of that?

Ms. MONSEAUX. That was done as part of our investigation. We started to see exactly what his background was and that was how we found out that he——

Senator DODD. But you don't recall whether or not he held himself out as being a current member of that association?

Ms. MONSEAUX. There was a plaque for the association. I don't remember him saying anything specifically about it.

Senator DODD. And during the 8-month period the Astris were handling the account you never received a written statement on the status?

Ms. MONSEAUX. At my request, I received two statements when I returned in September. My account had been open for 2 months and at that point I called him and he did send me the two statements, one for the month that I opened and one for the month following the month that I had opened the account. But I did not receive statements routinely each month after that.

LARGE FIRMS VS. SMALL FIRMS

Senator DODD. Ms. Roper, you raise some excellent points. You talk about fees as one way of possibly dealing with this issue—larger fees. Is it the experience that the larger firms, the size of a firm—in this particular case—and I will learn later I suppose how typical the size of the firms are—but am I being naive when I suggest that the smaller the operation, the more likely for this kind of a problem? The larger the firm, where you can run into problems with individuals, at least as a business operation you're less inclined to run into these kinds of problems?

Ms. ROPER. Well, con men rarely operate in large firms. They are rarely found working for the big, well known insurance and brokerage companies. So, yes, to a certain extent you're more vulnerable when you go to a smaller planner. However, many of the best planners operate in small firms. So there's no simple answer to your question there. In fact, in many of the larger firms we found that the problems of self interest are stronger because the firms place more pressure on their employees to sell.

But the reason we talk about increasing fees is sthat they are currently too low to cover the cost of inspections, particularly for larger firms. As I understand it, it costs $150 to register, and it's the same if you're a 1-person office or if you're a 6,000-person office.

Senator DODD. My point would be, you've cited in the study that came out yesterday or today from the North American Securities Administrators—you're talking here, if the numbers are right, you're talking billions of dollars. I mean, increasing the fees, given the kind of attraction that this business can pose for those inclined to engage in fraudulent activities——

Ms. ROPER. Raising fees alone clearly is not going to keep fraudulent practitioners out. You have to inspect them and you subject them to real oversight, and raising fees helps pay for that. I've talked to planners who are now in operation who have been planners for 10 years and have never been inspected. Currently, con men, can call themselves a financial planner and no one is immediately alerted to look over their operation to see if it is legitimate. There is no single agency that immediately says, "that's someone who's under my jurisdiction."

Second, even if they go to the trouble of registering—and some of the people cited in that NASAA study are registered investment advisers—they can feel fairly confident that they're not going to be

inspected. As I say, the SEC has done an excellent job in focusing on the right kind of people to inspect and trying to increase their inspections with a limited staff, but realistically they don't have the staff to inspect these planners as they come in on a regular basis and to continue that kind of oversight.

So we don't think that there's one thing that you can do that solves the problem, but we think that there is a series of steps that you take that improve disclosure, that strengthen oversight, and that toughen prosecutions of planners who are in violation so that you create an overall disincentive for these people to set up as planners.

Senator DODD. In other words, you're talking about those fees going directly to the SEC to fund the operations for inspections?

Ms. ROPER. Right. CFA does not support earmarking, for tax reasons, but we do think fees should be raised as a source of increased revenues that could help Congress find the funds to improve inspections.

Senator DODD. You point out that insurance agents and real estate advisers are regulated by the States in your testimony. Do you think they should also be subject to the investment adviser laws even if they don't give advice with respect to securities?

Ms. ROPER. When they call themselves financial planners, they are implying that they give that kind of comprehensive advice. We think that, if they're not, that's a deceptive practice that is confusing to the consumer and it ought to be ended. If they do make that kind of implied claim, they ought to be held to the standards that the claim justifies.

Senator DODD. Commissioner, we thank you for coming here this morning. You mentioned Ivan Boesky could open up shop tomorrow in Maryland.

Ms. BROWN. Not tomorrow. I hope the Federal penal system will have him for a little while longer. It won't be tomorrow.

Senator DODD. I thought maybe you knew something we didn't know. But you do have antifraud statutes in Maryland.

Ms. BROWN. Yes.

Senator DODD. And wouldn't those statutes pick up these kinds of issues despite the fact that you've raised some good points about specific laws?

Ms. BROWN. They really are not adequate and, frankly, in certain situations, time is of the essence. I think we have a good example in my office right now where, had we been entitled under a financial planning statute to move quickly to inspect records, rather than go through a subpoena process—frankly which we could undertake only because we had good cause to believe that there had been unregistered securities sales and therefore we had jurisdiction—but if we had had an inspection statute, I think we could have moved much more quickly and possibly could have preserved assets for eventual distribution to investors that we now believe are gone.

Senator DODD. And you would not be able to do that under the Maryland antifraud statutes?

Ms. BROWN. No. We have no authority to do that right now.

Senator DODD. I wonder if you might give some of the ideas that you have in the educational area. Obviously, that's a major front.

You mentioned important cases, good cases and so forth, but what other suggestions would you make with regard to improving the level of education?

EDUCATING THE PUBLIC

Ms. BROWN. I'm sure that there have been those before you who are more expert than I in that area, but with the focus in our schools now on literacy and reading ability and the fundamentals of living skills, I think we need to think of financial literacy as a part of that type of education. Education may help to eliminate the extraordinarily vulnerable consumer who is available for the plucking by the real con artist, as Ms. Roper has described him.

I think that education can reach that fairly small portion of the victims, people who are so naive that they really don't understand anything. As a related example, I can tell you that we have had investors call our office who truly did not understand that stock prices could go down as well as up. I wouldn't put Miss Monseaux in that cateory; although she has financial naivete, she does not fall into the same category as many of her fellow plaintiffs in the Astri lawsuit. She may have wished for more financial sophistication and gone to Ed Astri looking for assistance, and in fact looking to educate herself in many ways to become more financially sophisticated, but she wasn't someone who couldn't read or add or was basically unable to deal with any kind of financial issues at all.

Senator DODD. Miss Monseaux, I gather it was through a friend or an ex-friend maybe who——

Ms. MONSEAUX. A friend.

Senator DODD. Had this friend dealt with Mr. Astri?

Ms. MONSEAUX. That friend and several of her acquaintances had dealt with him on taxation and small investments—insurance, that sort of thing.

Senator DODD. What had their experience been with him?

Ms. MONSEAUX. They had no problems with him. They recommended him. As a matter of fact, they found him to be very helpful and they felt that the service that they had gotten from him was good.

Senator DODD. Well, I want to thank you for coming here today. This is not an easy thing to sort of bear your soul.

Ms. MONSEAUX. I wish I had left it in the bank.

Senator DODD. Yes, and that would be the first one I guess, but in addition to the questions and the other things that you wish you had done, but it is difficult to come forward and tell a personal story and I want you to know that I appreciate your willingness to do that because that is exactly what the commissioner is talking about; it's those kind of stories that help make people more aware of the situation.

I'll now turn to my colleague, Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

There are a couple of areas I'd like to pursue. One is the issue of the appropriateness of this area for a professional regulatory scheme; and then, second, whether that scheme should be at the State or Federal level.

Ms. Roper, what have you found to be the availability to potential clients of financial planners of information which they could refer to in order to make an informed judgment as to whether this individual was in fact what he represented himself to be?

Ms. ROPER. Well, if the consumer is sophisticated, and knows what questions to ask, and knows the warning signs when to say, "clearly this person is not what I'm looking for," they can do a fairly good job. They can ask for the disclosure documents that the SEC requires investment advisers to provide, and they can read it. That assumes that the information on that document is accurate, which may not always be the case. They can ask a number of questions of the planner about how he earns his money and if they find that that planner is reluctant to provide that information, they can leave and go someplace else.

DISCLOSURE INFORMATION

So, there is disclosure information available. As I say, we'd like to see some of that information improved. In particular, it can be awfully hard to distinguish some of these disclosure documents from slick promotional brochures, and so we would like to see a limitation on the form that disclosure can take so that the person has in front of them in very clear black and white what the important information is.

But for the consumers—who I would say are the majority of consumers—who don't know what questions to ask and who simply take on faith the information that the planner provides them, they are very vulnerable. They don't have a good means of assessing those statements.

Senator GRAHAM. In your experience, are a high proportion of the people who are using the services of financial planners in that category of the unsophisticated, unable to protect themselves?

Ms. ROPER. There are a whole range. And there are people that I would call unsophisticated consumers who wouldn't normally fit the definition of someone who's unsophisticated—well-educated individuals who are so confused by the financial markets and so lacking in time to acquire the kind of knowledge that they need to assess the advice that they get, that when they come to their role as financial planning consumers, yes, I'd say the majority of consumers are fairly unsophisticated and many of them are completely unsophisticated.

Senator GRAHAM. Ms. Brown, you mentioned that Maryland does not have regulation of financial planners as such. Has this proposal been considered by the Maryland legislature?

Ms. BROWN. The proposal that is in draft form right now has not been previously considered by the Maryland legislature. The Maryland legislature has considered different bills in the past several sessions and has rejected them for a variety of reasons. I think there were no votes because some members of the legislature didn't think that the proposals were adequate or strong enough, but other members may have been opposed because they were opposed to the idea or substance of regulation of financial planners. We'll just have to see how this particular proposal, which will be new to our

legislature, will be received in this coming session, which begins in January 1989.

Senator GRAHAM. You mentioned at the end of your remarks about a partnership, including industry, Federal and State government. What would you see as the Federal Government's role in that partnership?

FEDERAL GOVERNMENT'S ROLE

Ms. BROWN. I would certainly agree with Ms. Roper that the SEC has a good system in place for monitoring investment advisers. It needs to be better funded, better staffed, and should be tuned up to be a more effective enforcement tool. I think that the SEC is a good place for broad oversight to remain. It is also necessary for States to be involved in enforcement and registration simply because it's much more likely, I think, in the areas of what I would call "grassroots consumer fraud," or intrastate fraud, if you will, that States are a little more mobile. We can move fast when we hear from constituents in our own State. It may be easier to move quickly without the SEC having to worry about jurisdictional issues, having to move into a State, having to get long-distance statements or work through long-distance communications. I think that there's a great facility—the States, securities divisions being the sort of the bantam weight fighters of securities regulators—in that we can move fast, as we need to, provided we're properly funded and we have good enforcement capacity. I think we can do a good job in that area.

Senator GRAHAM. Thank you, Mr. Chairman.

Senator DODD. Have you had a chance to look at the North American Securities study?

Ms. BROWN. I have not seen it yet.

Senator DODD. They make a number of very good recommendations—that consumers inquire about planner's experience, professional background, length of time in the community—questions like that. Any thoughts at all in the State of Maryland, for instance, about putting out material or brochures or other things to people through banks or savings and loan associations, places like that where people have assets and are inclined—or getting the banking community in the State or others to include this kind of information in statements and so forth?

Ms. BROWN. We have actually begun to do some work in that area. We've been fortunate to have some good press about a number of financial planning cases. In fact, one reason to believe that the Maryland General Assembly will act this year is that members are getting alot of comments from citizens who are either aware of or have themselves been victims of financial planners.

In the course of these cases we have now designed our "ten tips for choosing a financial planner": questions to ask, how to go about discussing compensation arrangements, et cetera. We're trying to work in that direction. It's very difficult to really reach people with pamphlets and brochures. It's been my experience, particularly in the financial area, that it's tough to make it look interesting and appealing and to have consumers read it the same way that they're

going to read an advertisement that's designed by a slick ad agency.

Senator DODD. Last, I wonder, Ms. Roper, I'm going to ask Chairman Ruder when he follows you about how the data on the number of people and the amount of money involved—could you just briefly describe the methodology that CFA used in arriving at the numbers that you cited this morning?

Ms. ROPER. Well, are you talking about our estimate of how many planners there are or our estimate of the level of abuse?

Senator DODD. Well, both.

Ms. ROPER. OK. We did an estimate of how many people there are who hold themselves out as financial planners. We used the broadest possible definition since legally there's no restriction on the term. We said anyone who calls himself a financial planner for our purposes is one, and we looked at listings in the yellow pages of 20 of the largest cities in the country. We chose our cities to provide some variety so that we weren't too stacked toward one type of city. We analyzed those listings to get numbers of people who had listed. Then we conducted our own survey of Washington planners calling 30 of the yellow pages listings randomly out of the book to see how many of those, when actually approached with a personal call would identify themselves as someone offering personal financial planning. We adjusted our figures according to our findings.

We then made some assumptions—frankly, it's been long enough since I did that that I forget exactly what they are—about what size of firms these people operate in. In other words, when you have a listing, how many people are going to be employed there. We used the IAFP's membership survey, their breakdown of the size of the firms who are members of the IAFP. We then made an estimate about what our 20-city total represented as part of a national total.

As we point out in the study, it's a very loose estimate. You've got to make so many assumptions that you can't be too exact in your estimate but we think there's been substantiation that our estimate is at least within the ballpark. For example, in California alone, their securities administrator there told me, they have 60,000 planners. So if California has 60,000, then I think it's fairly safe to say that there are somewhere around 250,000 in the Nation, maybe more.

Senator DODD. If California has 60,000, why would it be fair to say?

Ms. ROPER. Well, if you estimate from California as a representative part of the national population, then——

Senator DODD. Well, I presume there are financial planners not just based on population.

Ms. ROPER. Well, no, but 60,000 is a big chunk of 250,000. It's nearly a fourth and we're talking about 49 other States, including New York, Arizona, Florida, where there are large planning populations. So I am pretty comfortable that we're at least in the ballpark.

Senator DODD. I didn't mean to spring that on you, but maybe you would like to respond in writing to what math you did use and provide it?

Ms. ROPER. Sure. We provided the committee with a copy of our report in which the method behind the estimate is outlined in detail. But if you don't have that, I'd be happy to provide it.

[The following information was subsequently submitted for the record:]

variously squandered, invested inappropriately, or churned away in commissions by a financial planner affiliated with a registered broker-dealer. The victims in this case included blue collar retirees who cashed in pension funds to place money with the financial planner, teachers who learned about the planner through his marketing efforts to their unions, and many other middle income persons who sought and were promised solid, conservative investment strategies and got anything but.

In other cases of which we are aware, where no action of the financial planner has given rise to our jurisdiction under the Maryland Securities Act, we have no choice but to counsel victims that their only recourse is to seek competent private counsel to pursue their civil claims. We have no way, under Maryland law, to seek an injunction or otherwise bar such a financial planner from future activities that will, predictably, create a new crop of victims. In a few such instances, where we can locate a Virginia or Pennsylvania nexus, we have been able to refer matters to our sister states, both of which have financial planning statutes.

Because the Securities Division has no jurisdiction over financial planners, per se, it is unlikely that we hear about most of the problems encountered by consumers. Therefore, it is very difficult to ascertain the level of financial planning fraud and abuse in Maryland. We have no way to gauge what, if any, amount of low level dishonesty or incompetence may exist in the financial planning community in Maryland. Unfortunately, we most

often hear about problems at the point where the fraud is completed and the complainants' funds are gone.

Unfortunately, the statute has yet to be written, by Congress or the Maryland General Assembly, that will put a complete stop to financial fraud and abuse. Frauds can be perpetrated, even in heavily regulated industries like the securities industry, and regulation, no matter how comprehensive, can never guarantee against fraudulent behavior. As Securities Commissioner, I know of cases in which a registered agent of a registered broker-dealer walked out of his office with hundreds of thousands of dollars of client funds, never to be seen again. Mere regulation will never make these kinds of disasters disappear, no matter how stringent it may be.

As this Committee knows well, long term solutions are difficult to legislate. A basic understanding of financial tenets, markets and terms is necessary for every investor. Such consumer education must begin in the schools; it simply cannot be accomplished by pamphlets available from Boulder, Pueblo, Colorado, no matter how many millions of dollars government may be willing to spend. Adequate monitoring and enforcement capacity, at both the SEC and the state level, is also key. Fully-staffed investigations and prosecutions are time consuming and expensive, but they can stop those who will otherwise find future victims. Good cases also make good press and good educational tools to alert the investing public.

Today's financial marketplace is extremely complex: new investment vehicles and instruments are created almost every day, and consumers are understandably anxious about their knowledge and abilities to manage and maximize hard-earned funds for housing, education, retirement security and other important family goals. Adequate regulation of financial planners is necessary and, we hope, imminent in Maryland. Availability of a centralized registration system for financial planners, which we hope is also imminent, will enable Maryland and other states to communicate effectively about problem planners and enforcement matters. Nonetheless, an investor's life savings can never be surrendered to any financial planner entirely free from risk of loss by mistake, mismanagement, or, as we have seen, fraudulent intent. Each investor must assume responsibility for keeping a close watch on his or her funds to protect not only the return on the money, but the return of the money.

ELB/djr

100,000 part-time employees of A. L. Williams, who call themselves financial planners in order to sell term life insurance and some mutual funds. (The A. L. Williams organization is a general agency for Massachusetts Indemnity and Life Insurance Company. 15)

It seems reasonable to conclude, based on the figures from California and on our own examination of the yellow pages that, if you use a broad definition of planner, there are at least 250,000 and possibly as many as 400,000 individuals nationally who list themselves as financial planners in the yellow pages.

15 "A New Term Policy from the A. L. Williams Organization," The Insurance Forum, 12 (1986): 144.

One of the best studies of abuse by financial planners was conducted in 1985 by the North American Securities Administrators Association (NASAA) as a survey of 20 state securities regulators on the subject of enforcement actions related to financial planners. The study reported consumer losses of approximately $90 million over the three-year period studied, 1982 through 1984, through alleged fraud and abuse by individuals holding themselves out as financial planners. About half of that amount was lost in the last year of the study. NASAA estimated that they had captured about one-half of the cases in the country and issued a statement that financial planning fraud and abuse was at least a $90 million a year problem. 44

The report was valuable in revealing for the first time the types of fraud being practiced by financial planners, but its findings about the extent of that abuse have been controversial.

44 "Recent Developments," Tax Management Financial Planning Journal 1 July 1986: 340.

When the report was first released in August 1985, Director of the Georgia Securities Division Wayne Howell analyzed the results this way: "What we're seeing now is the first stage of an epidemic of fraud and abuses arising from the underside of the financial planning industry. The current era is a made-to-order incubator for financial fraud." 45 SEC Chairman John R. Shad, on the other hand, used the survey results to bolster his argument that existing regulation of financial planners is adequate, since abuse represents "a small fraction of one percent of the funds under management." 46 Daniel Bell III, North Carolina Securities Division Director and NASAA President, said he believes Shad took the report out of context. "The figure reported in the study was never presented as being complete," Bell said. "It is the tip of the iceberg. It represents only those cases reported to the states or discovered by state inspections in a scenario in which many of the abuses were not reported and many states have weak inspection programs." 47

Our own survey of 14 state securities administrators 48

45 Clemens P. Work with Joseph Benham, "About that 'Can't Miss' Investment Offer ... " U.S. News and World Report 26 August 1985: 55.

46 John Shad, Chairman of the Securities and Exchange Commission, "Concerning Investment Advisers and Financial Planners," Subcommittee on Telecommunications, Consumer Protection and Finance of the U.S. House Committee on Energy and Commerce, 11 June 1986: 5.

47 Daniel Bell III, personal interview, December 1986.

48 California, Florida, Georgia, Idaho, Maryland, Massachusetts, Michigan, New Jersey, New Mexico, New York, North Carolina, Tennessee, Utah, and Washington.

leads us to concur with Bell, that the numbers revealed by such a study represent only a small percentage of the total abuse. Half of the state securities administrators we spoke to could not provide us with details of all cases, because statistics on financial planners are not kept separately from other securities cases. For this reason, in all but a few cases, we were forced to rely on the administrator's memory, which many admitted was incomplete. In California, the securities division began this year to look specifically for the role financial planning plays in securities fraud cases. As a result, the number of revealed cases involving financial planning violations has approximately doubled over the past year. 49 In December 1986, the state had 64 cases, 15 percent of the total case load, in which financial planning activity was a major issue or critical aspect. 50 The most common infractions included failure of the planner to register under the Investment Adviser's Act, abuse of private placement laws, abusive tax shelters, undisclosed commissions, self-dealing, and lack of due diligence. 51 Unfortunately, the securities division cannot provide details such as dollar amounts lost and numbers of victims, because such statistics are not kept separately for financial planners.

49 Bill McDonald, Assistant Commissioner in the Securities Division of the California Corporations Commission, personal interview, December 1986.

50 McDonald, interview.

51 McDonald, interview.

Senator DODD. I'd appreciate that very much.

Bob, do you have any further questions?

Senator GRAHAM. No, Mr. Chairman.

Senator DODD. Well, I want to again thank all three of you for being here this morning and particularly, with all due respect to the other two, particularly Miss Monseaux for telling her story.

Chairman David Ruder, Chairman of the Securities and Exchange Commission, who will be accompanied by Kathryn McGrath, who is the Director of the Division of Investment Management. Mr. Chairman, we appreciate your taking time to be with us this morning. We welcome you.

STATEMENT OF THE HONORABLE DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Chairman Dodd and members of the subcommittee, I appreciate this opportunity to participate in this hearing concerning financial planners. I am accompanied this morning by Kathryn B. McGrath, Director of the SEC's Division of Investment Management. She has submitted a written report which I ask to be included in the record.

She will also have an opening statement this morning.

Financial planners have become a significant segment of the financial services industry in the 1980's as consumers have sought their services to plan for retirement, reduce taxes, or otherwise provide for their future financial security.

A financial planner is a person whose business consists of providing comprehensive financial advice to individuals. Most financial planners, either directly or through affiliates, sell securities and other products to clients to implement the recommendations they make in financial plans.

The products most frequently sold are mutual funds, limited partnership interests, and insurance. Most financial planners are regulated as investment advisers because in conducting their business they give advice about securities. The Commission registers and regulates investment advisers under the Investment Advisers Act of 1940. At least 40 States also regulate investment advisers and impose requirements comparable to ours.

However, because of several exemptions in the Advisers Act, not all financial planners that fall within the definition of investment adviser are regulated by the Commission.

First of all, there's a broad exemption for banks and their employees. Additionally, persons engaged in selling insurance and other nonsecurities products are excluded unless they recommend securities. There are also narrow exclusions for lawyers, accountants, engineers, teachers, and broker-dealers whose investment advice is solely incidental to their professions.

Broker-dealers who do have an exclusion will not fit this exclusion, however, if they receive special compensation for their advice.

Director McGrath will be discussing current Commission initiatives regarding financial planners, but I would like to note briefly an important initiative in this area.

This initiative derives from the fact that broker-dealers who are also investment advisers and fall within both definitions are also

subject to regulation by the Commission and the self-regulatory organizations under the Securities Exchange Act of 1934. The primary self-regulatory organization regulating broker-dealers is the National Association of Securities Dealers.

In May 1987, the NASD announced that it would support expanding its jurisdiction to become a self-regulatory organization for NASD members and persons associated with NASD members that are investment advisers and would in fact take on a second function in their regulatory pattern.

ADVISER SELF-REGULATION

The idea of adviser self-regulation deserves serious consideration because this type of regulation offers important resources that enhance the ability of Federal and State regulators to maintain an active examination program in the face of continued industry growth. Self-regulation would provide an important mechanism to increase surveillance of the advisory industry at private rather than public cost. Government resources would, of course, be used for oversight of the self-regulatory organization.

The NASD proposal is currently limited, as I've indicated, to investment advisers who are also broker-dealers or associated persons of broker-dealers. Our staff has asked the NASD to consider whether it would be feasible for the NASD to expand the scope of the proposal to cover all investment advisers, whether or not they are broker-dealers, and it is waiting for an NASD response before deciding whether to recommend such a step to the Commission.

There is one matter not involving financial planners that I would like to bring to the attention of the subcommittee, if I may. On June 13, 1988, the Commission transmitted draft legislation to members of the Senate Committee on Banking, Housing and Urban Affairs entitled "The Shareholder Communications Improvement Act of 1988". This act would improve communications between investment companies and their beneficial shareholders by requiring nominee shareholders, broker-dealers, and banks in particular to deliver proxy materials and information statements to beneficial shareholders. The legislation also would require investment companies to transmit information statements to nominee shareholders and require nominee shareholders of noninvestment company shares to deliver information statements to beneficial shareholders.

We believe that the omission of investment companies from prior legislation regarding shareholder communications was unintentional and that, as a practical matter, many investment companies already comply with the shareholder communications provisions of the securities laws. Increasing numbers of investment company shares are being held in nominee name by broker-dealers and banks and we believe that the legislation will be noncontroversial, that it's much needed, and we urge your support of that provision.

Mrs. McGrath will now make her opening statement. Thank you.

Senator DODD. Thank you very much, Mr. Ruder.

STATEMENT OF KATHRYN B. McGRATH, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, SEC

Mrs. McGRATH. Chairman Dodd and Senator Graham, I'm glad to be here this morning. As Chairman Ruder stated, most but not all financial planners are investment advisers because they give advice about securities in conducting their planning business, and so the SEC and a majority of the States regulate these planners under our investment adviser laws.

The securities sales activities of financial planners, in addition, are subject to broker-dealer regulation by the SEC, the self-regulatory organizations—stock exchanges and the NASD—and the States as well.

With few exceptions, investment advisers must register with the SEC. Our regulatory system relies mainly on disclosure, but we also require advisers to keep certain books and records and to make them available to Commission inspectors or examiners.

Under the Investment Advisers Act of 1940, advisers are fiduciaries and, as fiduciaries, we require that they disclose all material information about conflicts of interest that could impact their advice to clients.

We require registered advisers to give clients a brochure that spells out their business practices, what type of advice they give, what they charge for that advice and so forth, their education and business background, and we require that they disclose certain disciplinary information to clients.

QUALIFICATION OR TESTING IS NOT REQUIRED UNDER FEDERAL LAW

There are no qualification or testing requirements for advisers under Federal law. Many States, however, have some type of adviser qualifications or are giving serious consideration to testing the knowledge of individuals seeking State adviser licenses.

The SEC, through our regional offices, conducts periodic surprise inspections of investment advisers to determine their compliance with the law. The violations we find usually are resolved informally, although a small number—about 5 percent—result in enforcement referrals.

As Senator Dodd said in his opening statement, today we have 14,200 registered investment advisers. That's up quite a bit from 1981 when there were 4,580. These include large institutional money managers as well as retail level financial planners. Of the registered advisers, 7,840 or 55 percent identify themselves as financial planners, so we think this is our biggest growth area in adviser registrants.

It's important to note, however, that because of the exclusions that Chairman Ruder mentioned and because the SEC registers only firms and not individual employees of the firms who may hold themselves out as financial planners, the number of our registrants is going to be much, much smaller than the number of individual financial planners.

We've taken a number of steps to try to deal with the increase in the number of investment advisers, and particularly financial planners.

The principal thing has been to try to work much more closely with our colleagues in the States to see if we can, by pooling our resources, get better coverage. Last fall, together with the States, we put out a joint interpretative release to make financial planners more aware of how the securities laws, State and Federal, apply to them. We have also worked with the States to come up with uniform registration forms and to try to make our other requirements more uniform and we have worked with the States to inspect advisers.

Last September, we put in a rule spelling out an adviser's duty to tell clients about their legal or disciplinary history that may bear on the adviser's integrity and to tell clients if the adviser is in financial difficulty.

During 1988, about 40 percent of the inspections we do of advisers will be of financial planners. Because our resources haven't kept up with industry growth, we've taken a number of steps to try to keep our inspection program effective. We rely more on risk profiles to determine who to inspect. We have increased staff productivity quite a bit—118 percent in the last 8 years—by focusing on riskier aspects of the registrant's business and through management controls and, thanks to Chairman Ruder, by getting more computers.

As I said, we've also been working with the States to try to share our resources in the inspection area.

At the request of the House Subcommittee on Telecommunications and Finance, we conducted a study of investment advisers and planners. The staff report was sent to that subcommittee this February and it's appended to my prepared statement. It gives statistical information about planners and their clients and reviews recent SEC experience in conducting inspections.

We found that the types and significance of the violations for planner registrants aren't really different than those for other types of advisers, although there were more violations and more deficiencies found in the case of planners.

We thought as a result of this study that the close connection of many planners with the sale of products does create a potential for self-interested behavior, but the report showed that abuse involving advisers and planners relates to a small portion of the industry.

Nevertheless, when abuse does occur it's very serious, particularly for the individuals involved, and we and the State regulators take it very seriously and pursue all available remedies.

Since 1983, we have brought 275 enforcement actions against investment advisers and since January 1987 at least 13 of the cases against investment advisers authorized by the Commission have involved financial planners. Almost all of these cases have involved fraud allegations.

We are very interested in financial planners' impact on the investing public, particularly the many individual investors to whom planners give advice and sell securities. It's critically important that these investors be given adequate protection through effective enforcement of Federal and State securities laws, including prohibitions against securities sales practices abuses and other forms of overreaching. We've been fortunate to have had the active support and cooperation of our colleagues, the State securities administra-

INFORMATION REQUESTED ON ESTIMATED NUMBER OF FINANCIAL PLANNERS

How Many Financial Planners Are There?

Prevailing estimates of the number of financial planners practicing nationally range from 50,000 to the most commonly cited figure of 250,000, but no one we interviewed could explain how these estimates were calculated. They seem simply to have appeared in news magazines a few years ago and to have been used ever since. The first estimate is obviously low, since California securities administrators say there are 60,000 individuals holding themselves out as financial planners in California alone. 9 The other estimate is more difficult to judge. We believed, therefore, that it would be valuable to try to calculate such an estimate. To do so, we used the broadest possible definition of financial planner, because, for the consumer, a financial planner is quite simply anyone who calls himself one and who claims to offer financial planning advice.

9 Bill McDonald, Assistant Commissioner in the Securities Division of the California Corporations Commission, personal interview, December 1986.

The Method behind the Estimate

We counted the listings under financial planners and financial planning consultants in the yellow pages of the 20 cities (see footnote 8) to arrive at a total, eliminating as far as possible any duplicate listings. From that total, we then subtracted 30 percent, as our survey of Washington planners had revealed that approximately that number would either have gone out of business or would immediately inform a caller that they did not offer personal financial planning. 10

The listings we analyzed included everything from one-person offices to national firms with staffs of thousands of planners. The listings, however, give no information about the size of the firm. We determined that the best source of such information was the 1985 membership survey of the International Association for

10 Among the services they did provide, according to our Washington survey, were corporate financial consulting, specialized portfolio management, corporate benefit consulting, and credit repair.

Financial Planning (IAFP), the largest membership organization for planners. To arrive at its results, the IAFP mailed 10,561 questionnaires and received 2,517 responses, 63 percent of which were from planners. 11 The responses from planners were tallied separately from others, and it is those figures that we used.

According to the IAFP survey:

1) 37 percent of financial planning employees are in firms of 1 to 3 employees;

2) 20 percent are in firms of 4 to 7;

3) 13 percent are in firms of 8 to 15;

4) 10 percent are in firms of 16 to 50;

5) 6 percent are in firms of 51 to 500;

6) 3 percent are in firms of 500 to 1,000; and

7) 12 percent are in firms of over 1,000. 12

(We believe a slight skewing of these numbers toward higher percentages in the larger categories occurs as a result of the increased likelihood that more than one employee of the larger firms answered the survey. To counteract that skewing, we used the lowest employee figure in each category for our calculations.) Furthermore, not all planning employees are financial planners; some are clerical, technical, or administrative staff. According to the IAFP survey, 51 percent of employees actually

11 "Summary: 1985 Membership Survey" 1.

12 "Summary: 1985 Membership Survey" 3.

work with clients as a planner, 13 so we used this figure to further adjust our calculations.

Applying these percentages to our 20-city listings total, we arrived at 120,000 as an estimate of the number of financial planners in those 20 cities. The IAFP survey indicates that 39 percent of all planners are located in metropolitan areas of one million or more. 14 There are 40 metropolitan areas in this category, but according to our figures, approximately two-thirds of the population and possibly as many as three-fourths of the financial planners in this demographic category can be found in our 20 cities. We therefore determined that approximately 30 percent of the financial planners in the country are represented in our sample.

The Estimate

The national total we arrived at was approximately 400,000. This number should not be taken as an exact total. As the description of the method makes clear, it was necessary to rely on assumptions in several areas, because exact figures simply are not available. On the other hand, this estimate should not be dismissed simply because it seems high. We believe the logic behind the calculations is correct, and, at every step, we used the most conservative figures available. Also, by using the broadest definition, we included in our total, for example, the

13 "Summary: 1985 Membership Survey" 3.

14 "Summary: 1985 Membership Survey" 8.

Our survey of 14 states uncovered $125 million lost as a result of alleged fraud and abuse by financial planners in 1985 and 1986. We believe that this figure represents, at most, one-half the dollar value actually involved in fraud and abuse in those states, and that losses in those states probably represent approximately a third of the national total for the two-year period. Just under three-fourths of the total, or $90 million, was detected in 1986. This leads us to conclude that alleged fraud and abuse was at least a $540 million problem nationwide in 1986. We further conclude, on the basis of the Consumer Reports study, our survey of Washington planners, the experience of the few clients we interviewed, and media reports on sales incentives, that although individual cases of self-interest and incompetence may not compete with securities fraud cases in dollar amounts involved, the former problems are more widespread. As a result, we believe more money is misinvested each year through bad advice arising from one of these two problems than is lost through securities fraud. If you combine all three forms of abuse, it becomes clear that abuse by financial planners should be measured not in the millions, but in the billions of dollars.

tors in doing this, and we look forward to continuing to cooperate with the States and this subcommittee, the securities industry self-regulatory organizations, and professional associations in the financial planning industry, all of whom are, as we are, interested in protecting the interests of consumers who seek to plan for their financial futures.

Thank you.

[The complete prepared statement of Mrs. McGrath and a report from the SEC follow:]

STATEMENT OF KATHRYN B. MCGRATH
DIRECTOR OF THE DIVISION OF INVESTMENT MANAGEMENT
SECURITIES AND EXCHANGE COMMISSION
BEFORE THE CONSUMER AFFAIRS SUBCOMMITTEE OF THE SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING FINANCIAL PLANNERS

July 26, 1988

EMBARGOED
JUL 26 1988
UNTIL

Chairman Dodd and Members of the Subcommittee:

My name is Kathryn McGrath, and I'm Director of the SEC's Division of Investment Management. I appreciate this opportunity to testify concerning financial planners.

The term "financial planner" has come to be used to describe persons whose business consists, in whole or part, of providing comprehensive financial advice to individuals. Based on information the client provides about the client's current financial situation and objectives, the typical financial planner will develop a program for the client to achieve goals such as saving for retirement, reducing taxes, and providing for the education of children. The plan may include recommendations about budgeting, appropriate levels and types of insurance coverage, the need for tax and estate planning, as well as recommendations for suitable types of investments.

The client may implement the plan by purchasing the types of investments, insurance or real estate recommended, and taking the other actions suggested. The vast majority of financial planners will sell the recommended investments and insurance products to the client either directly or through an affiliated sales organization. Financial planners will monitor the client's situation periodically to determine if changes to the client's plan or portfolio of investments are needed. Because there is no regulatory definition of "financial planner", anyone can use the title, whether or not he or she provides the type of services described above.

Financial planners generally receive fixed or hourly fees for their advice and planning services in addition to commissions on products sold to clients. Some, however, are compensated solely through commissions earned by implementing plans for clients and a few charge only a fee for advice and do not earn commissions from product sales.

CURRENT REGULATION OF FINANCIAL PLANNERS

The term "financial planner" does not appear, and is not defined, in the federal securities laws. However, the Investment

Advisers Act of 1940 ("Advisers Act") defines investment adviser to include "any person, who, for compensation, engages in the business of advising others *** as to the value of securities or as to the advisability of investing in, purchasing, or selling securities ****." Most persons engaged in financial planning today give advice to their clients about securities and therefore fall within this definition. As a result, they are subject to investment adviser regulation, unless they qualify for certain exclusions or exemptions. There is a broad exclusion from the statutory definition of investment adviser for banks and bank employees, and there are narrow exclusions for lawyers, accountants, engineers, teachers and broker-dealers whose investment advice is solely incidental to their professions. The exclusion for broker-dealers also requires that no special compensation be received for the broker-dealer's advice. 1/ A financial planner who comes within one of these exclusions, or whose financial planning does not include advice about securities, is not an investment adviser under the Act. With few exceptions, investment advisers must register with the Securities and Exchange Commission. 2/

1/ Broker-dealers and their employees that offer financial planning services are subject to comprehensive federal and state broker-dealer regulation whether or not they also are subject to regulation as advisers. The exclusion from investment adviser regulation for accountants, lawyers and teachers that provide investment advice as part of financial planning services has been construed narrowly by the Commission's staff and state regulators. As was stated in I.A. Release 1092, the exclusion "is not available, for example, to a lawyer or accountant who holds himself out to the public as providing financial planning, pension consulting, or other financial advisory services. In such a case it would appear that the performance of investment advisory services by the person would not be incidental to his practice as a lawyer or accountant."

In light of the foregoing, I believe that federal and state securities regulation covers most persons and firms engaged in the financial planning business today. The principal exceptions would apply to banks and bank employees and planners who recommend or sell only investments not involving securities, e.g., insurance or real estate.

2/ The Advisers Act provides exemptions from registration for:

(1) an adviser all of whose clients are residents of the state in which the adviser's business is located if the adviser does not give advice about securities

(continued...)

The system of registration and regulation under the Advisers Act is designed to disclose basic facts about the adviser and to hold each to high standards of honesty and loyalty. 3/ The Commission's so-called "brochure" rule requires that registered advisers, with few exceptions, provide clients with information about the adviser's education and business background, 4/ the

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2/(...continued)
listed or traded on any national securities exchange;

(2) an adviser whose only clients are insurance companies; and

(3) an adviser who has had fewer than fifteen clients in the preceding twelve months who neither holds himself out generally to the public as an investment adviser nor acts as an adviser to a registered investment company or a business development company.

3/ The Commission is authorized to deny the registration of an adviser, or to deny or place limitations on the ability of a person to be associated with an adviser, if the adviser or person has been convicted of certain crimes within the last 10 years, or has been enjoined by a court from specified activities or future violations, or has been found by the Commission to have engaged in violations of the laws specified in the Advisers Act. Advisers are required to report past disciplinary information on Part I of Form ADV for the adviser and persons connected with the adviser, including all employees other than those performing only clerical, ministerial or support functions. This information is publicly available.

Additionally, Rule 206(4)-4 requires advisers to disclose to clients any disciplinary history that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients. The rule also requires advisers to disclose to clients any precarious financial condition of the adviser if the adviser has discretionary authority over, or custody of, client funds and securities or charges large prepaid fees.

4/ Information is required about the formal education after high school and business background for the preceding five years of each member of the committee or group that determines what advice is given to clients. If there is no such committee or group, information is required for each individual determining the investment advice given to (continued...)

types of advice offered, and the methods of analysis, sources of information, and investment strategies the adviser employs. There are no qualification requirements for investment advisers at the federal level. However, 28 states impose experience or knowledge requirements, and 17 states impose financial responsibility requirements. The Model Amendments to the Investment Adviser Provisions of the Uniform Securities Act of 1956, which are intended to strengthen state adviser laws and make them uniform, if enacted by the individual states, would require advisers to pass certain tests and to meet certain financial responsibility criteria. The Model Amendments were developed by the North American Securities Administrators Association (NASAA) 5/ which is preparing a uniform state law examination for use by the states that have or adopt testing requirements for advisers.

The antifraud provisions of the Advisers Act require advisers to meet the high standards owed by persons who are fiduciaries. The Supreme Court has stated that an adviser owes his clients "an affirmative duty of 'utmost good faith, and full and fair' disclosure of all material facts." 6/ The adviser's duty to disclose material facts is particularly pertinent whenever the adviser is in a situation involving a conflict, or potential conflict, of interest with a client. The Advisers Act also contains provisions relating to advisory contracts which generally prohibit advisers from being compensated on the basis of capital changes in the client's account and which require that an advisory contract cannot be assigned without the client's consent. Advisers must maintain prescribed books and records and make them available to Commission examiners. The Commission inspects registered investment advisers to help ensure compliance with the various federal requirements as to recordkeeping, reporting, advertising, conflicts of interest, and other matters and to determine if advisers are acting in accordance with the disclosures and representations made to clients.

Financial planners that sell securities to their customers generally are subject to federal and state broker-dealer regulation and must be registered as broker-dealers or as representatives of broker-dealers. At the federal level,

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4/(...continued)
clients, but if there are more than five such persons, the information may be given only for supervisors.

5/ Since the Model Amendments were endorsed by NASAA in November 1986, they have been enacted in three states.

6/ SEC v. Capital Gains Research Bureau, 375 U.S. 180, 184, (1963) (quoting Prosser, Laws of Torts (1955), 534-535.)

registered broker-dealers and their associated persons are subject to a comprehensive regulatory scheme designed toward the end that customers be treated fairly, that they receive adequate disclosure, and that the broker-dealer is financially capable of transacting business. Broker-dealers also are required by the Securities Exchange Act of 1934 ("Exchange Act") and the rules of self-regulatory organizations ("SROs") 7/ (to which all broker-dealers must belong), to maintain reasonable supervision over employees to prevent violations of the federal securities laws. Unlike the Advisers Act, the Exchange Act authorizes standards of training, experience, competence and other qualifications, and the SROs have set qualifying standards for members and associated persons. Qualifying examinations test knowledge of products that are sold, of the markets in which the products are sold, and of the laws and regulations that govern sales activities. Under SRO rules, recommendations made to customers by a broker-dealer or its registered representatives must be suitable in light of the customer's financial resources, sophistication, and investment objectives. In addition, SROs have established guidelines for the content and review of advertising materials. Finally, broker-dealers must maintain prescribed records which are subject to periodic and surprise inspections by the Commission and the SROs, to help ensure compliance with applicable regulations, including those relating to sales practices.

THE INVESTMENT ADVISORY INDUSTRY

Since 1981, the number of investment advisers registered with the SEC has increased about 210%, from 4,580 to about 14,200, and the assets they assist in managing have increased an estimated 900%, from about $440 billion to over $4.4 trillion. 8/ (About 20% or $885 billion is held by managed registered investment companies.) The types of advisers range from sole proprietorships to large multi-office firms. About 11% of registered advisers are also registered as broker-dealers and 41% of registered advisers indicate they are associated with a broker-dealer. It appears that the growth in the number of registrants reflects, at least in part, growth in the financial planning industry. With the implementation of Uniform Form ADV in 1986, the Commission has been able to identify separately the

7/ Self-regulatory organizations under the Exchange Act include the national securities exchanges, i.e., the New York Stock Exchange, American Stock Exchange and the regional stock exchanges; and the National Association of Securities Dealers ("NASD"), a registered securities association.

8/ Source: SEC Investment Adviser Data Base as of July 18, 1988.

number of investment adviser registrants who are financial planners. Their number has increased from approximately 6,022 as of March 30, 1987 to 7,800 as of July 18, 1988. It is important to note, however, that, because of the exclusions in the Advisers Act for banks and broker-dealers and their employees, as well as for certain lawyers and accountants, and because the Commission registers firms and not individuals, the number of financial planner registrants always will be significantly smaller than the number of individuals giving investment advice as financial planners.

SEC INITIATIVES INVOLVING FINANCIAL PLANNERS

As a result of the growth in the financial planning industry, the Commission has given increased attention to adviser regulation and to financial planners. Significant initiatives include:

A. IA-770 and IA-1092

In August 1981, the Commission published Investment Advisers Act Release No. 770 9/ on the "Applicability of the Advisers Act to Financial Planners, Pension Consultants and Other Persons who Provide Investment Advisory Services as a Component of Other Financial Services." The release describes the activities of financial planners and sets forth the staff's view that, because financial planners typically give advice about securities for compensation as part of their financial planning services, they generally would be investment advisers within the meaning of the Advisers Act. The release also describes applicable requirements including those imposed under the Advisers Act's antifraud provisions. In October 1987, in cooperation with NASAA, the Commission published an updated version of the release, Investment Advisers Act Release No. 1092. Release IA-1092 was developed jointly by the Commission and NASAA 10/ to provide uniform interpretations of the application of federal and state adviser laws to financial planners. The new release contains additional examples of the application of the antifraud laws to the activities of financial planners and also updates the 1981 release.

B. Uniform Form ADV

To reduce administrative burdens on advisers registering with several states and the Commission and to improve the

9/ IA-770, August 13, 1981.

10/ IA-1092, October 8, 1987.

information reported by advisers, the Commission and NASAA developed a uniform registration form for investment advisers. Uniform Form ADV, which took effect in January 1986, is used by the Commission and the states to register advisers. The Commission and NASAA expect to develop a central processing system for adviser registrations similar to the Central Registration Depository, developed by NASAA and administered by the National Association of Securities Dealers, Inc. ("NASD"), which is used to register broker-dealers and their agents in the states. This would permit advisers to become registered with the SEC and the states in which they do business by sending one Form ADV to the processing entity and paying the required registration fees.

One goal in developing the uniform ADV was to obtain identifying and other information about financial planners. The new form asks applicants holding themselves out as financial planners to provide data on the number of clients served and their total investments in financial products based on those services. In addition, new questions were added to identify the types of conflicts of interest likely to arise for financial planners. One such question asks whether the adviser solicits clients to invest in partnerships for which the adviser or a related person serves as general partner. 11/ Other questions elicit information about adviser relationships with entities selling investment products to advisory clients.

C. Staff Report on Financial Planners

At the request of the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, the Commission staff conducted a study of financial planners. The Subcommittee had asked for a report on the status of the industry, including the "degree of abuse." The Subcommittee also requested specific information on the demographics of planners and their customers and other characteristics of planners, including information concerning compensation, registration and oversight by regulators. 12/ The staff report, Financial Planners, was transmitted to the Subcommittee in February 1988. A copy is appended to this statement.

11/ Approximately 8% of registrants report that they do.

12/ The Subcommittee also asked for an evaluation of the NASD's pilot program to inspect certain NASD broker-dealers registered as advisers with the Commission. The NASD pilot was intended to test whether the NASD should seek to expand the NASD's jurisdiction to become an SRO for investment advisers. The NASD initiative is discussed below.

The staff report is based on data derived from a review of industry and academic studies, surveys, articles and news reports concerning financial planners; the SEC computerized data base; special inspections of 100 registered investment advisers that are financial planners; a special review of all SEC reports of inspections of investment advisers conducted in 1986; and a special review of a random sample of Forms ADV filed by advisers that are financial planners.

The staff found that the "typical" client of a financial planner works as a business person or professional, and is college educated and relatively well off financially. Most financial planners work independently or for small business organizations, are located in major metropolitan areas, and are college educated. Many planners are members of trade associations or professions that have qualification standards or examinations. A significant "other business" of many financial planners is the sale of financial products; a large percentage of financial planners derive an important part of their income from commissions on sales of financial products. The products most frequently sold are mutual funds, limited partnership interests, and insurance.

The staff report found that financial planners are less likely than other advisers to have discretion to make securities trades for clients or to choose brokers or determine commissions for clients. Thus, the risks these practices pose--that trades inconsistent with client objectives will occur or that a broker will be chosen on a basis other than quality of service to the client--generally are not present with financial planners. Nor are financial planners likely to take custody of client funds or securities. Only approximately 3% of all advisers have custody and of these 56% are broker-dealers.

The principal risk to clients of financial planners derives from the conflicts of interest arising when planners also sell products to clients. The special inspections conducted by the Commission staff revealed that over 85% of the inspected planners sold products to clients, either directly or through affiliates, and that employee time in the inspected firms was devoted more heavily to product sales than to planning. The specific risks posed to clients are that conflicts of interest will not be adequately disclosed, that implementation of plans will be limited by the products offered by the affiliated sales organization, and that investments may be recommended with a view to the planner's self-interest rather than with a view to what is most appropriate for the client. More than other types of advisers, financial planners often recommend that clients purchase limited partnership interests. For example, 36% of the registered advisers that manage securities portfolios for clients

on a discretionary basis report recommending real estate limited partnerships to clients while 88% of the planners report that they make such recommendations. 13/ Limited partnership investments may pose a greater risk to clients than other, more traditional, investments for a number of reasons: they are subject to less comprehensive disclosure requirements, since many are exempt from registration under the Securities Act of 1933; they often are illiquid; and many involve speculative business ventures. 14/

D. SEC Inspections and Enforcement Actions

1. Inspections

Through its regional offices, the Commission conducts on-site examinations of the books, records, and operating activities of registered investment advisers. The primary purposes of these inspections are to ascertain whether the adviser is in compliance with the Advisers Act and SEC rules and to ascertain whether the adviser's practices described in its Form ADV are consistent with the information disclosed to clients. Inspections focus on books and records, sales materials, investment activities, and the adviser's relationships and agreements with clients and affiliates. Since 1980, the percentage of advisers inspected each year has varied from a low of 11.0% in 1988 to a high of 13.9% in 1982. To keep pace with industry growth and maintain inspection levels in the 11% to 12% range over the last four years, the Commission's staff has taken steps which increased the productivity of the inspection staff by over 118% in eight years, from 10.6 inspections per staff year in 1980 to 23.1 in 1988. We have sought to improve the use of inspection time by tailoring inspections to focus on the perceived risk in a particular adviser's operations and by better coordinating our inspections with those conducted by state regulators. This coordination has included:

(1) development with NASAA of Uniform Form ADV which provides additional computer-usable data for use in inspections;

13/ Source: SEC Investment Adviser Data Base as of July 18, 1988.

14/ In the past, many limited partnership investments were regarded as good tax shelters. This may no longer be the case because of the Tax Reform Act of 1986.

(2) a program under which the Commission staff has trained and worked in cooperation with examiners in 20 states; and

(3) the exchange of inspection schedules and findings with state examiners in order to increase inspection coverage and minimize duplication of state and federal efforts.

The Commission also has targeted for inspection advisers who pose a greater risk to client assets because of the nature of their businesses, or because of information in the Commission's possession indicating possible problems. New advisers also are targeted for inspection, although resources do not permit the Commission to visit every new adviser during its first year of operations.

Deficiencies found in inspections usually are resolved informally by sending a deficiency letter to the registrant pointing out the violation and asking the registrant to confirm that corrective action has or will be taken. Some deficiencies are resolved on-site during the inspection. During 1988 to date, approximately 4% of inspections resulted in enforcement referrals; the percentage has ranged between 4% and 6% since 1980. Deficiencies are categorized by type, e.g., books and records, financial matters, custody arrangements, fees, and advertising. The staff report found that types of deficiencies reported for financial planners were similar to those reported for all advisers although the incidence of deficiencies was higher for financial planners than for other advisers. Of the 294 financial planner inspections conducted in 1986, no deficiencies were reported in 28% of the inspections. For the remaining 72% of inspections, deficiency letters were issued in 66% of all inspections while 6% were resolved on-site. This compares to 49% of inspections resulting in findings of deficiencies for all investment advisers.

The most frequently found violations for financial planners included:

(1) failure to keep required books and records;

(2) failure to keep registration information current or to comply with the requirement to offer brochures to clients on an annual basis;

(3) contractual problems involving the use of exculpatory or so-called "hedge" clauses and the failure to include non-assignability clauses or to disclose client refund policies; and

(4) violations of the advertising rule, Rule 206(4)-1. 15/

Deficiencies in recordkeeping and registration, including the brochure requirements, accounted for more than 50% of the deficiencies reported for financial planners.

2. Enforcement

Since January 1983 the Commission has brought enforcement actions against 275 investment advisers. 16/ These actions often involve charges of more than one type of violation with the most common charges being fraud (83% of all cases), violations of books and records requirements (34%) and failure to register (23%). Generally, cause inspections, 17/ public complaints, and referrals from other regulators or from informants have accounted for most SEC enforcement actions. However, 16% of enforcement actions result from routine inspections.

In SEC enforcement actions under the Advisers Act, as well as under the Exchange Act, the sanctions imposed on persons found to have violated the law can include censure, suspension or bar from serving as an investment adviser or broker-dealer, or court ordered injunctions against future violations. The SEC also can refer violations to the Department of Justice for criminal prosecution which can result in sanctions of fines or imprisonment.

In compiling enforcement data, the Commission historically has not differentiated between advisers who are financial planners and those who are not. Therefore, complete data on the number of SEC cases against financial planners is not available. However, a review by staff of the Division of Investment Management of recent adviser enforcement cases indicates that, since January 1987, the Commission has authorized at least 13

15/ Rule 206(4)-1 sets forth a general antifraud standard for adviser advertising and proscribes certain practices such as using testimonials or highlighting past recommendations that would have been profitable without providing a complete list of recommendations.

16/ This number does not include cases brought against broker-dealers unless they also were registered or required to be registered as advisers.

17/ The term "cause inspection" denotes an inspection that occurs because of information in the Commission's possession about possible problems.

enforcement actions under the Advisers Act against financial planners.

In one such recent case, the Commission found that a financial planning company, registered as both an adviser and broker-dealer, and one of its principals, had breached their fiduciary duty to advisory clients by failing to state they would receive commissions for the sale of securities recommended to clients; failing to disclose that clients could purchase securities from a broker-dealer other than the company; recommending securities that were unsuitable for clients; and failing to comply with the brochure rule. The sanction in this settled administrative proceeding was a censure of the company and the suspension of the principal, for 120 days, from being associated with an investment adviser, broker-dealer, municipal securities dealer or investment company. 18/

In another recent case the Commission obtained an injunction against a registered investment adviser and its principal on the basis of a complaint alleging, among other things, that on the principal's advice at least 96 advisory clients remortgaged their homes and invested the proceeds, approximately $2.7 million, in the adviser's "College Assistance Program" and that, although clients were told there was little or no risk involved in this program, their funds were placed in highly speculative ventures controlled by the principal. 19/

E. NASD Proposal Concerning Self-Regulation of Advisers

In May 1987, the NASD announced that it would support expanding its jurisdiction to become an SRO for investment advisers that are NASD members or their associated persons. The NASD proposal followed a pilot program begun in the summer of 1986 to test the feasibility of the concept.

The NASD proposal would cover NASD members, associated persons of NASD members, and entities whose personnel are associated persons of NASD members. About half the registered advisers are "dual registrants," i.e., advisers that are both registered with the Commission and either an NASD member or associated with an NASD member. The activities of investment advisers to registered investment companies would not be covered. The proposal, which would be modeled after the system of SRO regulation created for broker-dealers under the Exchange Act,

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18/ Investment Advisers Act Release No. 1117 (May 16, 1988).

19/ SEC v. Jeffers, et al., C88-2138 N.D. Ohio, Eastern Division, June 28, 1988.

would give the NASD broad authority to establish qualifications standards, perform inspections, and enforce members' compliance with the law and applicable requirements. All of these activities would be subject to Commission oversight. Amendments to the Advisers Act would be needed to authorize an adviser SRO of this type.

At the request of the House Subcommittee, the staff report included an evaluation of the NASD pilot. Based on an analysis of NASD inspection reports and the reinspection of a sample of the advisers examined by the NASD, the staff found that the pilot program generally desonstrated the ability of NASD inspectors to conduct adviser examinations. Although SEC reinspections of advisers examined in the pilot revealed deficiencies missed by NASD inspections, including two instances of problems serious enough to warrant enforcement referrals, the differences in thoroughness may be attributed primarily to NASD inexperience in administering adviser requirements rather than to an inability of NASD inspectors to understand the business operations and range of investment products offered by advisers. The staff report expresses concern that, if the NASD were to inspect its adviser members, sufficient time and resources must be given to adviser inspections. Also, although the NASD traditionally has focused broker-dealer inspections on the central offices of broker-dealers, branch office inspections would be necessary to oversee advisers, particularly financial planners, because they are much more likely to be located in branch offices. While the staff evaluated the NASD's performance of the pilot inspections for the report, it did not analyze the merits of the NASD proposal.

The staff currently is reviewing the NASD proposal to determine what recommendations to make to the Commission. We have asked the NASD to consider whether it would be feasible to expand the scope of the proposal to cover all investment advisers and to determine what draft legislation would be needed to implement the proposal. We also have sought the views of various segments of the advisory community. In June we asked interested organizations to provide us with copies of any statements or position papers they may have developed. We are still receiving these responses.

The Division has stated that the idea of adviser self-regulation deserves serious consideration because of federal and state resource limits which impair the ability of regulators to maintain an active examination program in the face of continued industry growth. Self-regulation would provide a mechanism to increase surveillance of the advisory industry, at private, rather than public, cost. Government resources would be used for oversight of the SRO. The NASD proposal would cover a significant portion of the adviser population. An SRO can set and enforce standards more effectively than can trade

associations or voluntary professional associations. To the extent an SRO were successful in maintaining high qualification standards, state regulators might defer to it to establish nation-wide standards. Both federal and state regulators could defer to it in the area of practice standards. This would decrease the cost and burdens of regulatory compliance on those in the financial planning business.

Nevertheless, there are significant arguments against adviser self-regulation. Unlike broker-dealers, advisers typically do not engage in financial transactions with one another for their own account or on behalf of clients and thus have less self-interest in the regulation of the financial viability, qualifications and practices of other advisers. Also, the great diversity in the advisory industry could make it difficult to establish industry-wide standards. For these reasons, adviser self-regulation may not be cost-effective. To date, there seems to be little support in the advisory industry for the type of SRO proposed by the NASD.

The staff hopes to complete its review of the NASD proposal and to make a recommendation to the Commission this fall.

I would be pleased to respond to any questions of the Committee on my testimony.

FINANCIAL PLANNERS

Report of the Staff of the
United States Securities and Exchange Commission
to the
House Committee on Energy and Commerce's
Subcommittee on Telecommunications and Finance

The Commission has authorized publication of this report but has expressed no view on the findings it contains.

February 1988

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

February 12, 1988

The Honorable Edward J. Markey
Chairman
Subcommittee on Telecommunications
and Finance
Committee on Energy and Commerce
H2-316 House Office Building
Annex II
Washington, D.C. 20515

The Honorable Matthew J. Rinaldo
2469 Rayburn House Office Building
Washington D.C. 20515

Dear Chairman Markey and Congressman Rinaldo:

I am pleased to transmit Financial Planners: Report of the Staff of the United States Securities and Exchange Commission to the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance. The report is a study of the financial planner industry, and is in response to the Subcommittee's July 9, 1986 request. It examines a number of areas relating to the financial planner industry, including: customer demographics, characteristics of planners, and the regulatory program for registering and inspecting planners. The report also evaluates the National Association of Securities Dealers' pilot program to inspect NASD members who are also investment advisers.

The report, which was prepared by the Commission's staff, has not been reviewed by the Commission and does not represent the Commission's views.

Sincerely,

David S. Ruder

David S. Ruder
Chairman

Enclosure

cc: The Honorable John D. Dingell
The Honorable Norman F. Lent

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I. INTRODUCTION

The Securities and Exchange Commission ("SEC") staff has prepared this report at the request of the House Committee on Energy and Commerce's Subcommittee on Telecommunications, Consumer Protection and Finance ("Subcommittee"). 1/

The Subcommittee requested the SEC to study further the questions concerning the financial planner and investment adviser industry that were raised during the Subcommittee hearings. 2/ The Subcommittee generally requested a report of the status of the industry, including the "degree of abuse." The Subcommittee also requested specific information on the demographics of planner/advisers, their customers and other characteristics of planner/advisers, including compensation, registration, and oversight by regulators. Finally, the Subcommittee asked for an evaluation of the National Association of Securities Dealers' ("NASD") pilot program to inspect certain NASD broker-dealers also registered as investment advisers with the SEC. The NASD pilot program was intended to test whether the NASD should seek to expand the NASD's jurisdiction to include regulation of some aspects of the investment advisory business of member firms.

This report addresses both the general and specific questions posed by the Subcommittee. Chapter II, Summary, summarizes the findings of the report. Chapter III, Overview, describes the methods used to collect the data used in the report. Chapter IV, Methodology, offers a brief description of the financial planner industry. Chapter V, Findings, responds to the Subcommittee's questions. A subchapter discussing the SEC's enforcement program concerning investment advisers is included in the Findings chapter in response to the Subcommittee's concern about abuse in the planner/adviser industry. Chapter VI, NASD Pilot Project, evaluates the NASD's pilot inspection program. Appendix A,

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1/ That request, contained in a July 9, 1986, letter to the Chairman of the SEC from former Subcommittee Chairman Timothy E. Wirth and Ranking Minority Member Matthew J. Rinaldo, is attached as Appendix C. On January 1, 1987 at the inception of the 100th Congress, 1st Session, the name of the Subcommittee was changed to the Subcommittee on Telecommunications and Finance.

2/ Investment Advisers, Financial Planners and Customer Protection: Hearing Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. (1986) [hereinafter Investment Adviser, Financial Planner Subcomm. Hearings].

History of the Investment Advisers Act, presents the history of the Investment Advisers Act of 1940 1/ (the "Advisers Act"). Appendix B, The Operation of the Investment Advisers Act, describes the present statute.

Appendix C is a copy of the letter from former Subcommittee Chairman, Timothy E. Wirth, and Ranking Minority Member, Matthew J. Rinaldo, requesting the report. Appendix D is a glossary of terms. Appendix E is a copy of Form ADV.

1/ 15 U.S.C. § 80b-1 et seq.

II. SUMMARY

The report first describes the methodology used to gather data in response to the Subcommittee's questions. Four basic data sources were used. Data derived from the second, third and fourth sources were limited to those financial planners over whom the SEC has regulatory jurisdiction, i.e., those planners who are investment advisers.

1) Data found in the literature: A review was made of industry and academic studies, surveys, articles, and news reports concerning financial planners (the "literature"). This source provided information about financial planners generally, and about planners who belong to particular professional associations.

2) The SEC's own data: The SEC tapped the computerized database of information investment advisers include in the form used by advisers to register with the SEC (Form ADV), and the computerized database of enforcement matters found in the Case Automated Tracking System ("CATS").

3) Data generated specifically for the report: To supplement data already in existence, the SEC a) conducted special inspections of 100 registered investment advisers who were also financial planners; b) specially reviewed all SEC reports of inspections of investment advisers conducted in 1986; and c) specially reviewed a random sample of Form ADV of advisers who were also financial planners and who were registered with the SEC on March 30, 1987.

4) The NASD pilot review: The NASD conducted special investment adviser inspections of a selected number of volunteer NASD broker-dealer members who also are registered investment advisers. The SEC reinspected some of the firms to evaluate the NASD's performance.

The findings of the report are presented next. With regard to questions concerning financial planner clientele, the report finds, among other things, that the "typical" client of a financial planner is male, middle-aged, married, working as a business person or a professional, generally college educated, and

relatively well off. With regard to the characteristics of planners, the report finds, among other things, that most financial planners work independently or for small business organizations, that generally they are located in major metropolitan areas, that the average individual planner is male, middle-aged and college educated. There are no federal qualification standards or qualifying examinations for investment advisers or financial planners per se, but many planners are members of trade associations or professions that do have standards or examinations. The report also finds that a significant "other business" of many financial planners is the sale of financial products 4/ and that, accordingly, a large percentage of financial planners derive an important part of their income from commissions on sales of financial products. The products found to be most frequently sold are mutual funds, limited partnership interests, and insurance products.

Next, the report describes the registration requirements for financial planners under federal and state law and with self-regulatory organizations. Financial planners have to register with the federal government only if they are investment advisers within the meaning of the Advisers Act, or if they are broker-dealers as defined by the Securities Exchange Act of 1934 ("the Exchange Act"). The same is generally true with respect to state registration requirements. Some states, however, require that individuals register as investment advisers, as well as firms. The federal registration requirement only reaches firms; individuals employed by registered advisers do not have to register separately. The Advisers Act does not provide for the establishment of self-regulatory organizations for investment advisers, but there are a number of trade and professional associations to which advisers may belong.

The report also describes the SEC's program for conducting on-site inspections of registered investment advisers and provides information about the types of deficiencies typically found. The largest number of deficiencies comes from failure to make or maintain accurate books and records, or to keep or provide to clients accurate, timely and adequate registration information. These deficiencies typically are addressed through "deficiency letters" or other internal means, rather than through enforcement actions. The discussion of enforcement actions brought against financial planners by the SEC discloses that the majority of cases charge fraud, with the more serious or

4/ If the products sold are "securities" the planner is required to be registered with the SEC as a broker-dealer, or with a securities industry self-regulatory organization as a registered representative of a broker-dealer.

repeating record keeping violations also an important basis for bringing cases.

Finally, the report describes the results of a pilot inspection program conducted jointly by the NASD and SEC inspections staff. The advisers inspected were affiliated with NASD broker-dealer member firms, and had volunteered to be part of the program. The pilot demonstrated both the feasibility and ability of the NASD inspectors to conduct adviser examinations.

The report also includes five appendices. Appendix A provides a review of the history of the federal government's regulation of financial planners. Appendix B offers a description of the present federal regulatory scheme. As is set forth in these Appendices, the federal government has never regulated financial planners per se, but has regulated those planners whose activities meet the definition of "investment adviser" in the Advisers Act or "broker-dealer" in the Securities Exchange Act. 5/ Federal regulation of investment advisers began with the 1940 passage of the Advisers Act, and continues to this day. The original statute required little more than a federal registry of investment advisers. The Advisers Act has been amended several times, with the most recent and extensive amendments coming in 1970. The current Advisers Act is far more comprehensive than the original in the scheme it imposes, and contains disclosure, record keeping and antifraud provisions.

The remaining appendices make various sections of the report easier to understand because they contain the particular form or letter often referred to, or they define and give background on the terms or trade association acronyms frequently used. Appendix C is a copy of the letter from former Subcommittee Chairman, Timothy E. Wirth, and Ranking Minority Member, Matthew J. Rinaldo, requesting the report. Appendix D is a glossary of terms, including financial planner trade and professional associations. Appendix E is a copy of form ADV, which advisers that are registered with the SEC are required to complete and which constituted the data base for a significant portion of the information contained within the report.

5/ 15 U.S.C. §§ 78a-78jj.

III. OVERVIEW

Before describing the findings of this report, a brief discussion of the financial planning industry's place in the universe of investment advisers, and of the "typical" business environment in which financial planners function, may be helpful.

The term "financial planner" is not a precise term and includes a wide spectrum of advisory activity. An insurance agent may call himself a financial planner; so may a tax accountant, or a securities salesperson employed by a broker-dealer, or indeed anyone who wishes to use the term.

Since the passage of the Advisers Act, 6/ the SEC has regulated those entities in the segment of the financial planning community that meet the definition of "investment adviser" found in the Advisers Act. Investment advisers generally must register with the SEC and are subject to the provisions of the Advisers Act. Registered investment advisers include firms employing thousands of people, as well as small firms, as well as individuals. Broker-dealers must also register with the SEC and are subject to the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The primary focus of this report is an examination of financial planners who are investment advisers.

The definition of "investment adviser" in the Advisers Act 7/ is lengthy, complex and punctuated by exceptions, but generally the Advisers Act defines an investment adviser to be any person who is in the business of giving advice about securities for compensation. Many financial planners fit this definition, 8/ but it is important to emphasize that not all investment advisers are financial planners, and not all financial planners are investment advisers.

The number of investment advisers registered with the SEC has grown in recent years, 9/ perhaps due to the increase in the number of people engaged in financial planning. The SEC is not able to correlate precisely the rise in registrations with the

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6/ The Advisers Act was passed in 1940 as Pub. L. No. 76-768, 54 Stat. 847.

7/ Section 202(a)(11), 15 U.S.C. § 80b-2(a)(11).

8/ See Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987).

9/ Table 15 sets forth the registration figures. Chapter V.D, infra.

rise in financial planners because, until 1986, the SEC did not keep separate track in the registration database of investment advisers who identify themselves as financial planners. In addition, the number of advisers that register is only roughly correlated with the number of individuals engaged in the industry, since frequently a firm rather than its individual employees will register. Firms range in size from one individual to thousands of individuals.

People who give personal investment advice may be divided roughly into three groups depending upon the principal type of service they provide to clients. These groups are: discretionary money managers, non-discretionary money managers and financial planners. Some overlap exists among these groups, because an adviser can provide more than one type of service. For example, an adviser can also provide either discretionary or non-discretionary money management services, and many discretionary money managers also provide non-discretionary money management services.

A discretionary money manager's primary activity is to manage on a day-to-day basis a pool of liquid assets provided by a client in accordance with mutually agreed upon investment objectives. Thus, a discretionary money manager will invest and reinvest client assets without obtaining the client's prior approval as to the investment itself, or of the broker selected to effect the transaction, or of the commissions paid to the broker. Mutual funds and pension funds are serviced by discretionary money managers, as may be individual clients. Discretionary money managers usually are compensated on the basis of a percentage of the assets they manage for the client.

A non-discretionary money manager will often provide the same services as a discretionary money manager -- with one important exception: before the non-discretionary money manager may purchase or sell a security for a client's account, the non-discretionary money manager must first obtain the client's consent to effect the transaction.

Unless a money manager is a bank or broker-dealer, the money manager, discretionary or non-discretionary, is almost certainly required to register as an investment adviser under the Advisers Act, because the essence of the activity is to render advice regarding the purchase and sale of securities for compensation.

A financial planner usually does not manage client assets. Instead, the planner's primary service is to prepare a financial plan for the client, and to offer advice as to the purchase or sale of specific financial products appropriate to the implementation of the plan. As the name connotes, the planner's function

includes helping the client plan an investment strategy. 10/ If the advice given by the planner includes advice about securities (including limited partnerships, mutual funds and variable annuities), and if the planner is not exempted from registration under the Advisers Act, 11/ the planner is required to register as an investment adviser under the Act. 12/

The financial planning process is an individualized process that usually starts with an in-person interview of the client in which certain basic information is collected by the planner. The client is then usually given a detailed questionnaire to complete. The questionnaire requests information such as a client's current income, financial position, assets owned, family situation, insurance policies owned, and financial goals. The information from the questionnaire is then usually entered into a computer program, either directly by the planner or by a service bureau. 13/ For those planners who use computer programs, the output from the computer program usually forms the basis of the client's financial plan.

10/ Nothing prohibits a planner from also managing client assets. Of the 7,023 planners registered as investment advisers with the SEC as of October 1, 1987, approximately 700 (or about 10%) said that they provided discretionary money management services, and approximately 1,400 said they provided non-discretionary money management services.

11/ See infra Appendix B, text accompanying notes 26 to 29.

12/ As discussed elsewhere, there are a far greater number of people who are reported to be financial planners than are registered as investment advisers under the Act. The reasons for this discrepancy are discussed infra Chapter V.D.

13/ About 36% of the planners inspected by SEC staff in a random sample of 100 investment advisers registered with the SEC, reported that they prepared their plans without the extensive use of a computer, 60% were found to use an in-house computer to generate the plan, and 4% sent client information to a service bureau. [Hereinafter the data from these inspections is cited as the SEC Special Planner Inspections.] See infra Chapter IV.C.

Once the financial plan has been prepared it is presented to the client, usually in writing, coupled with an oral discussion. 14/

The content of financial plans varies from planner to planner. Most financial plans contain fairly general recommendations regarding the allocation of client assets among various kinds of investments. Seldom are specific securities or other products identified or recommended in the plan.

With some financial planners the process ends with the presentation of a financial plan, for which the planner is compensated by a fee. 15/ In the more typical situation, however, once the client is presented with the plan, the implementation of the plan includes the purchase of investment or insurance products specifically recommended by the planner, often from a product sales organization affiliated with the planner. Thus the planner may be affiliated with a broker-dealer, or with an insurance company, or both. And the planner's remuneration from the client may come more from commissions on the sale of products than from the fees generated by the preparation of the plan. 16/

The client may not always be aware of the product-sales tie-in to the planning activity. The tie-in can be obscure if the relationship is structured in a way that suggests that separate entities are engaged in the recommending and selling activities. Thus, in a hypothetical situation, the financial planning could be conducted by one or two individuals acting through an entity named (for example) "John Jones and Associates." The product sales activity could then be performed by the same individuals

14/ The SEC Special Planner Inspections found that 81% of the planners inspected present the plan in this manner. Another 16% provide an oral presentation only. Three percent provide the plan in writing without an oral discussion.

15/ The compensation of planners is discussed infra Chapter V.C.1.

16/ A study by the Consumer Federation of America of 30 financial planners in the Washington D.C. area found that it was not unusual for the planner to tell clients that investment recommendations could be given in a "free" brief meeting, in return for which the client would implement the planner's recommendations through the planner. The planner's compensation would then come from commissions on the sale of products. B. Roper, Financial Planning Abuses: A Growing Problem 17-18 (1987)(Report of the Consumer Federation of America) [hereinafter CFA Report].

operating under a different name -- "JKL Securities, Inc." The client may be unaware either of the relationship between the two entities or that the planner's remuneration is based on the kind of and number of products sold. 17/

In sum, the financial planning industry includes investment advisers as defined by the Adviser's Act, but does not consist exclusively of investment advisers. Conversely, not all investment advisers are financial planners. Financial planners are less likely than others rendering investment advice to manage customer funds and assets, but some do. Many, but not all, financial planners also sell or are affiliated with organizations that sell, financial products.

17/ The SEC Special Planner Inspections found that 47% of the planners informed prospective clients that they sold financial products, but that 85% actually sold products to clients. For a discussion of the disclosure requirements to which investment advisers are subject see infra Chapter V.C.3. One such requirement is that advisers disclose their financial interest in products they sell, but the disclosure is not always made or made clearly. Misstatements of such information by an adviser could result in charges being brought against it by the SEC pursuant to the disclosure and anti-fraud provisions of the Advisers Act. See infra Chapter V.F. and Appendix B.

IV. DATA SOURCES AND METHODOLOGY

The report used data from a variety of sources as described in this chapter.

Four major information sources were used: 1) published and unpublished reports ("literature"); 2) SEC in-house data, including the SEC's Form ADV database (the "ADV Database"), and a review of adviser deficiencies identified by the SEC's 1986 adviser inspections program (the "SEC 1986 Inspection Report Review"); 18/ 3) SEC inspections of a random sample of 100 registered investment advisers (the "SEC Special Planner Inspections"); and 4) a pilot review of adviser affiliates of NASD member firms conducted by the NASD (the "NASD Pilot Review").

A. Literature Review

The literature review consisted of collecting, examining, and summarizing the available literature on financial planners and investment advisers. The material spans several years, represents widely diverse viewpoints and ranges from the popular press to academic journals.

Surveys conducted by various industry associations proved particularly useful, although somewhat limited in scope because most surveys were confined to the associations' members. 19/ The surveys adduced detailed information about financial planners, their businesses, and, to a lesser extent, their clients. "Non-membership" surveys, i.e., surveys that cut across membership lines, helped to characterize the industry more generally since their scope was not limited to certain memberships. While the surveys taken together provided a wide array of useful material, their results could not easily be compared because each used different questions and different methods of recording the data. For example, one survey might categorize the age of planner clients as being in the "21 to 35 age group", while another might categorize the age group as "25 to 39." However, the survey results can be compared in a general way to provide useful information, both for an understanding of the industry and for comparison with the empirical reviews conducted for this report.

18/ Form ADV is discussed infra Appendix B, text accompanying notes 30 to 37. The SEC's inspection program is discussed infra Chapter V.E.

19/ A glossary of terms, including financial planner trade and professional associations, is provided in Appendix D.

B. ADV Database

The Act's requirement that advisers register with the SEC on Form ADV is described in Appendix B. 20/ The SEC keeps a computerized and constantly updated database of some of the information contained in the Form ADV. Unless otherwise noted, the ADV figures cited in the report are current as of September 30, 1987. At that time registered advisers totalled approximately 12,700. Over half of the registered advisers stated on the Form ADV that they provided financial planning services.

C. SEC Special Planner Inspections

1. Background

To collect in-depth, field-verified information on financial planners -- information not available from the literature or available databases -- the SEC's Division of Investment Management and SEC regional offices performed special inspections of a random sample of 100 advisers registered with the SEC, who stated on Form ADV that they offered financial planning services. 21/ The advisers registered with the SEC constitute the largest pool of identifiable "financial planners" registered with any regulatory body and thus provide a larger and more balanced sample than is otherwise available. In addition, the staff chose to inspect registered planners because the SEC clearly had jurisdiction over these planners for inspection purposes, allowing access to their books and records. The collection of information could also be "piggy-backed" onto the SEC's standard, on-site adviser inspection program.

The inspections took place from February to April, 1987; each took, on average, about four days in the field to complete.

20/ See infra Appendix B, "Registration as an Investment Adviser".

21/ The sample was selected from a list of all registered advisers who reported on their Form ADV that they provide financial planning or some similarly termed services. (See Appendix E, Item 20 on Part 1 of the Form ADV.) The number of advisers on that list was divided by 100 to obtain a quotient. The staff then selected planners, starting from the top of the list, with the frequency of that quotient, to obtain a random sample of 100. The inspections disclosed that only 81 of the 100 planners inspected were actively engaged in any type of advisory business. The other 19 were either in a business start-up phase or were inactive.

A typical adviser inspection, on the other hand, takes about two days.

The completed inspection outlines (described below) were sent to headquarters staff, where the data were entered in a computerized database for the purpose of tabulation and analysis.

2. Inspection outlines

The inspection outline that was used to collect the information gathered in the SEC Special Planner Inspections was divided into three parts: the registrant; clients; and the products sold by the registrant to clients. 22/

a. Registrant outline

The registrant outline sought to elicit information about the registrant's business. Items covered in the registrant outline included information on registration, organization, staffing, education, qualifications, clients, financial plan preparation, services provided, compensation, other businesses, types of products sold, and the registrant's financial interests in those products. Several items in the outline sought information about financial product sales activities of the registrant. Sales activities were of special interest because, as is discussed below, 23/ advisers who also sell financial products have a potential conflict between their duty to provide objective advice and their desire to sell products to their clients. The registrant itself answered the registrant outline. The SEC inspector then reviewed the data and followed up where needed.

b. Client outline

The client outline was used to elicit information about the clients of the inspected registrants. Client information is difficult to obtain because planners are reluctant to divulge the names of their clients, and the Paperwork Reduction Act 24/ discourages direct consumer surveys. The SEC examiners used

22/ The outlines were written by SEC headquarters staff, pretested both by headquarters and field staff, and then offered to the SEC field inspectors for comment. In this process outlines were revised several times before they were used to conduct inspections.

23/ See infra Chapter V.B.4., "Other business activities;" and Chapter V.C.1, "Compensation."

24/ 44 U.S.C. § 35 et seq.

clients' files to complete the outline but no individual clients were contacted. Items covered in the client outline included marital status, education, occupation, age, investment income, earned income, net worth, reason for seeking financial advice, investment objectives, the financial plan generally, special recommendations of the financial plan, commissions paid for products other than the plan, and the cost of the plan itself. In all, outlines were completed for 924 clients.

c. Financial product outline

The product outline explored the types of financial products bought from the registrants by the registrants' clients who were studied in the client outline. The information for the product outline was found in the files of the registrant, including the client files. Items covered in the outline included the type of product, whether and where it was registered, risk and liquidity, the amount invested by clients, and the total compensation provided to the registrant for sale of the product. An outline was prepared for each product purchased by a client, but duplicate product outlines were not prepared. Thus, regardless whether one, or fifty, or two hundred clients purchased a particular product, only one outline was completed for that product. Outlines were completed for 724 products, which means that the sampled clients of the sampled firms collectively purchased 724 products. The number of clients that purchased a product was also recorded on the product outline of that product. Thus, for example, if thirty clients purchased xyz product, that fact was included in xyz's product outline. The outline did not, however, record the total volume sold (in terms of shares, units, interests) of each product.

D. SEC 1986 Inspection Report Review

The adviser inspection reports, prepared by SEC inspectors as part of the SEC's regular inspection program, were another source of information for the report. The SEC's Division of Investment Management reviewed all adviser inspection reports completed during calendar 1986 -- a total of 1,337 reports. A coding sheet was then completed for each inspection of an adviser who could be identified as a financial planner -- 294 in all. 25/

25/ The number of advisers who were planners may actually have been higher because the inspection reports themselves do not necessarily identify an adviser as a financial planner. Information about an adviser's type of business is not usually noted in an inspection report unless that information relates to a deficiency in the adviser's operations. Starting in fiscal year 1988, the adviser's type of business (continued...)

The coding sheet was used to compile a 1986 inspection data-base containing the name of the registrant, location, assigned regional office, date of the inspection, types of deficiencies found, financial products sold, and any identified associations with either broker-dealers or insurance companies.

The coding sheets from these 294 inspections were analyzed to determine both the composition of the inspected group of financial planners and the deficiencies that were found. The deficiencies reported were then categorized under the twelve standard SEC adviser inspection focus areas. 26/ This information was used to supplement the information obtained in the SEC Special Planner Inspections.

E. 1987 Form ADV Review

A random sample of 100 planners was drawn from a listing of 6,022 advisers registered with the SEC on March 30, 1987, who had answered "Yes" to the question whether they provided financial planning services. Using a table of random numbers, a staff member picked the number 59. Starting with the fifty ninth planner on the list, every sixtieth planner was identified. The Forms ADV for these 100 planners were retrieved and reviewed to determine the kind of disclosures these planners made on Form ADV regarding their financial interests in products sold to clients.

F. NASD Pilot Review

The NASD announced in May, 1986, that it would perform a pilot inspection program to explore the feasibility of becoming a self-regulatory organization for the advisory activities of NASD members. On the national level the oversight and inspection of advisory activities is currently performed only by the SEC. Nearly half of the SEC registered advisers are also either registered with the SEC as broker-dealers or are affiliated persons of registered broker-dealers, and are thus "dual registrants." The broker-dealers are also members of the NASD. From the NASD member firms that volunteered to participate in the pilot inspection program, the NASD chose to inspect a diversified group of 50 firms of which 46 firms were actually inspected. Of these, 33 were actively engaged in financial planning. The inspected group included both large and small members.

25/(...continued)
will be noted in the inspection reports.

26/ These focus areas are described more fully infra Chapter V.E.2.a.

Following an orientation conducted by the SEC, NASD inspectors conducted the inspections. The NASD then furnished the Division with the results of the inspections of the 33 active firms. The SEC evaluated the NASD inspections by re-inspecting 15 of the 33 NASD inspected firms using experienced SEC regional office inspectors. To assure a fair comparison, the SEC inspectors were not given copies of the NASD inspection reports. Then the SEC headquarters staff reviewed the 33 reports and accompanying work papers of the NASD inspections and compared the NASD results with the results of the inspections of the 15 firms re-inspected by the SEC regional offices. 27/

27/ For a more comprehensive discussion of the NASD Pilot Project, see infra Chapter VI.

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V. FINDINGS

This part of the report responds to the questions posed by the Subcommittee. It is organized into seven sections. Six are in this Chapter: A. customer demographics; B. adviser characteristics; C. compensation of advisers; D. registration of advisers; E. inspection of advisers; and F. enforcement. The evaluation of the NASD pilot program is found in Chapter VI.

A. Customer Demographics

The Subcommittee posed the following questions concerning customer demographics:

> What are the demographic characteristics of financial planner/adviser customers?
>
> Are the customers individuals or institutions?
>
> If the customers are individuals, what is their: income level, educational background, reason for seeking financial advice generally and for selecting a particular planner/adviser, and previous financial experience?

The report presents information responsive to all of these questions except the last, which asked for data on the customer's previous financial experience. No information responsive to that question could be compiled within the scope of the report, which relied on information in the literature and obtained from planners, and not on information derived from direct contacts with clients. Other information about customers, such as income, net worth, and education was available, however. This information provides some idea of a customer's financial sophistication relative to the general population -- most probably the concern underlying the Subcommittee's question. The report also includes information on the knowledge and attitudes of customers concerning the regulation of financial planners.

The discussion of "Customer Demographics" is organized into seven topics: 1) "Client type," which discusses whether the customers are individuals or institutions; 2) "Demographics," which describes the age, sex, and marital status of customers; 3) "Profession," which describes the customers' occupations; 4) "Financial condition," which includes customer income and net worth; 5) "Education," which describes the educational level of customers; 6) "Reasons for seeking advice," which discusses why customers seek financial advice and why they choose a particular planner; and 7) "Consumer Satisfaction," which describes client satisfaction with planner services.

1. Client type

This section discusses the types of client that are served by advisers generally and financial planners specifically. The ADV Database was the source of this information. 28/

From information in the ADV Database, it is possible to divide adviser customers into six categories: 1) individuals; 2) corporations; 3) pension/profit sharing plans; 4) trusts, estates, and charities; 5) banks and thrifts; and 6) investment companies. Most advisers provide advice to more than one type of client. Of the total 12,700 advisers in the ADV Database, 85% advise individuals, 58% advise pension/profit sharing plans, 54% advise corporations or business entities, 45% advise trusts, estates, or charities, 14% advise banks and thrifts, and 13% advise investment companies.

Advisers can be separated roughly into two categories: advisers who are planners and those who are not. Individuals are by far the most common type of client for both. Table 1 sets out the percentage of planners and non-planner advisers who advise the various types of client.

28/ See Chapter IV.B.

Table 1

PERCENTAGE OF ADVISERS WHO
PROVIDE ADVICE TO THE FOLLOWING
TYPES OF CLIENT*

TYPE OF ADVISER	TYPE OF CLIENT					
	Individuals	Corporations	Pension Profit Sharing Plans	Trusts, Estates, Charities	Banks and Thrifts	Investment Companies
Financial Planners	98	61	57	42	9	5
Non-planners	70	46	60	49	20	23
Total	87	55	59	46	14	

Source: ADV Database

* Totals add to more than 100% because many advisers provide advice to more than one type of client and Form ADV requires the adviser to disclose all of the types of client to which it provides service.

The figures disclose that virtually all (98%) financial planners in the ADV Database give advice to individuals, although individuals are by no means their only clientele. More than half advise corporations and pension/profit-sharing plans, and almost half (42%) advise trusts, estates and charities. Only a small percentage advise banks and thrifts, and investment companies.

2. Demographics

This section describes the age, sex, and marital status of clients. The literature and SEC Special Planner Inspections were the sources of this information.

a. Age

A few professional associations have conducted membership surveys which include the age of their members' clients. The International Association for Financial Planning ("IAFP") conducted a membership survey in 1985 which reported the average client age to be 45 years. 29/ In a 1984 survey of National Association of Life Underwriters ("NALU") members, three out of four agents said that they primarily marketed to clients between the ages of 35 and 55. 30/ The IAFP's general population consumer survey revealed that 65% of high income ($50,000 or more annual income) customers were between 35 and 54 years of age, 19% were under 35, and 16% were over 55 years of age. 31/

The SEC Special Planner Inspections were consistent with the membership surveys in finding that most planning clients are middle-aged. The average age of financial planning clients in the inspected firms was 48.5 years and their spouses were an average of 45.4 years.

The typical client of a financial planner is thus most likely middle-aged (between 35 and 55 years old), and older than

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29/ Int'l Ass'n for Fin. Planning, 1985 IAFP Membership Survey Summary 11 [hereinafter 1985 IAFP Membership Survey].

30/ Nat'l Ass'n of Life Underwriters & Life Ins. Mktg. and Research Ass'n, The U.S. Survey of Agency Opinion, Volume 1: Sales Practices 15 (J. Kissane ed. 1985) [hereinafter 1985 NALU-LIMRA Survey].

31/ Reichman Research, Inc., IAFP Consumer Survey on Fin. Attitudes, Table 22 (responses to Q.5F) (June 1987) [hereinafter 1987 IAFP Consumer Survey on Fin. Attitudes].

the median age of the United States resident population (31.5 years). 32/

b. Sex, marital status

The few published membership and consumer surveys and the SEC Special Planner Inspections results all indicate that the "typical" planner client is likely to be male and is likely to be married. The IAFP membership survey found the typical client ratio to be 67% male and 33% female. 33/ The IAFP general population consumer survey reported that, of those who presently use financial planners, 57% were male and 43% were female. 34/ Interestingly, among the present financial planning clients identified as high income earners, only 47% were male and 53% were female.

Financial planning clients tend to be married. A study of client profiles administered for the Institute of Certified Financial Planners ("ICFP") showed that the majority of the ICFP members' financial planning clients were married. 35/ Similarly, the IAFP membership survey revealed that 80% of the clients were married. 36/ The IAFP consumer survey found that 84% of the high income respondents who presently use a financial planner were married. 37/

The SEC Special Planner Inspections showed similar results: 77% of the clients reportedly were married, 16% were single (never married), and 7% were divorced.

32/ Bureau of the Census, U.S. Department of Commerce, Statistical Abstract of the United States 17 (107th ed. 1987) [hereinafter Statistical Abstract].

33/ 1985 IAFP Membership Survey, supra note 29, at 11.

34/ 1987 IAFP Consumer Survey on Fin. Attitudes, supra note 31, at Table 22 (responses to Q.5F).

35/ T. Hira, H. Van Auken & D. Norris, Financial Planning Consumers: Who Are They, Why Do They Buy?, 7 J. Inst. Certified Fin. Planners 221, 223 (1986) [hereinafter Financial Planning Consumers].

36/ 1985 IAFP Membership Survey, supra note 29, at 11.

37/ 1987 IAFP Consumer Survey on Fin. Attitudes, supra note 31, at Table 22 (responses to Q.5F).

3. Profession

Only two sources found in the literature provided quantitative data about the professions of planner clients. Thirty-four percent of the IAFP members' clients reported being business owners, 31% corporate employees, 15% professionals, and 9% retirees. 38/ The study of ICFP client professions reported that 35% were business owners, 30% corporate employees, 25% professional, government, or educators, and 7% retirees. 39/

The SEC Special Planner Inspections found a somewhat different profile of planner client occupations. They found that the most common occupation of financial planning clients was business/legal professional (30%). The next largest segment of clients was retired persons (13%); followed by medical professionals (13%) and technical professionals (13%); 9% of the clients were proprietors of a business; 6% were academics; and 6% worked in the service industries. The professions were somewhat different among the clients' spouses. One-third (36%) of the clients' spouses were homemakers; 13% were business/legal professionals; 12% worked in service industries; 10% were academics; 9% were medical professionals; and only 7% were retirees. Table 2 summarizes the SEC Special Planner Inspections' information on occupations.

38/ 1985 IAFP Membership Survey, supra note 29, at 11. Eleven percent were "Educator, Military/Government, or Other."

39/ Financial Planning Consumers, supra note 35, at 224.

Table 2

EMPLOYMENT OF CLIENTS AND THEIR SPOUSES

	Client		Spouse	
	Number	%	Number	%
Business/professional	276	30	82	13
Retired	123	13	45	7
Technical professional	120	13	21	3
Medical professional	116	13	54	9
Proprietor of a business	80	9	28	4
Academic	55	6	61	10
Service industry worker	54	6	74	12
Factory worker	24	3	0	0
Not employed	21	2	24	4
Government	18	2	12	2
Homemaker	12	1	224	36
Armed forces	7	1	1	0
Construction worker	6	1	1	0
Farmer	4	0	2	0
Totals	916		629	

Source: SEC Special Planner Inspections
Item 3 of Client Outline

While a disparity exists between the percentage of clients who are business owners reported in professional association surveys (approximately 34%) and the percentage reported in the SEC Special Planner Inspections (9%), both the literature surveys and the SEC Special Planner Inspections indicated that most planner clients are from business or the professions and that very few are from traditional blue-collar occupations.

4. Financial condition

The surveys of planner clients reported in the literature show that planner client income and net worth is reasonably uniform throughout the industry and markedly higher than that of the general population. 40/ Fifty-three percent of the ICFP planners reported that their clients' income was typically between $50,000 and $100,000. 41/ Typical client income was between $25,000 and $50,000 for 25% of the financial planners and over $100,000 for 20%. 42/ Forty-five percent of the financial planners surveyed by the NALU reported that their typical client income was over $35,000 and 18% reported that their typical client income was over $50,000. 43/ A 1985 IAFP survey listed the typical client household income as $75,000. 44/

Average client net worth was over $350,000 for 51% of the ICFP surveyed planners. 45/ Twenty-six percent of the respondents reported that client net worth was between $150,000

40/ The average annual total compensation for the general population of the United States in 1985 was (including contributions for social insurance, private pension and welfare funds, etc.) $25,287 per full-time equivalent employee, and average annual wages and salaries were $20,991. The median household net worth for the general population was $32,667. Statistical Abstract supra note 32, at 400, 449.

41/ Financial Planning Consumers, supra note 35, at 223.

42/ Id.

43/ Life Ins. Mktg. and Research Ass'n, 1984 NALU-LIMRA Survey of Agency Opinion, cited in A Portrait of the Agent as a Financial Planner -- United States (1/R Code 7.30), Oct. 25, 1984, at 4 (hereinafter 1984 NALU-LIMRA Survey).

44/ 1985 IAFP Membership Survey, supra note 29, at 11.

45/ Financial Planning Consumers, supra note 29, at 223.

and $350,000 and for about 20% of the planners, client net worth was less than $150,000. 46/ The typical IAFP client's personal net worth was reported as $250,000. 47/

The SEC Special Planner Inspections also found that clients of planners are relatively affluent. The average combined (husband and wife) net worth (excluding principal residence) of financial planning clients was reported to be $405,640 while the median net worth 48/ was $250,000. The annual average combined earned income of these clients was $87,039 with a median combined earned income of $57,623.

5. Education

The surveys in the literature disclosed that people who seek financial planning advice are generally well educated. Over 60% of the ICFP members surveyed had clients who held at least college degrees, and another 20% reported that their clients had either a graduate or professional degree. 49/ An IAFP survey showed that 80% of the members' financial planning clients had earned a college or higher degree. 50/ In contrast, in 1985, only 19.4% of the general population over 25 years of age had completed 4 years or more of post high school education. 51/

The SEC Special Planner Inspections showed similar results. Nearly half of the clients (44%) had earned at least a college degree while another third of the clients (34%) had also earned a graduate or professional degree. Only 1% had not graduated from high school. On average, clients were reported to have attained higher levels of education than their planners (of whom 6% had not graduated from high school). Client spouses were also found to be well-educated. Almost half (48%) of the spouses had at least college degrees and approximately 15% of client spouses had graduate degrees; again, only 1% had not completed high school.

46/ Id.

47/ 1985 IAFP Membership Survey, supra note 29, at 11.

48/ Median net worth means that one-half of clients were above this level and one-half were below.

49/ Financial Planning Consumers, supra note 35, at 223.

50/ 1985 IAFP Membership Survey, supra note 29, at 11.

51/ Statistical Abstract, supra note 32, at 122.

6. Seeking advice

Both the literature and the SEC Special Planner Inspections provided information concerning the reasons customers seek financial advice and customers' means of finding a particular planner.

From one survey available in the literature, it appears that only a relatively small percentage of the population seeks financial advice. The IAFP consumer survey found that 13% of the total public and 22% of those with high incomes ($50,000 or higher income) used financial planner services. 52/ On the other hand, a recent study of subscribers to Sylvia Porter's Personal Finance Magazine, conducted for the ICFP, disclosed that 43% of the respondents currently use, or at one time used, the services of a financial planner. 53/ It is unlikely that these respondents are representative of the general public.

The reasons for seeking financial planning advice, as revealed both in the literature and in the SEC Special Planner Inspections, were relatively constant. The several reasons offered were: minimization of taxes, retirement planning, coping with inflation, saving for a child's education, and providing financial security for the family. 54/

The SEC Special Planner Inspections offered some insight into the reasons why clients seek out planners. SEC examiners looked at each client file to determine why that client sought

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52/ 1987 IAFP Consumer Survey on Fin. Attitudes, supra note 31, at Table 22 (responses to Q.5F).

53/ Inst. of Certified Fin. Planners, Utilization of Financial Planners: Consumer Survey 1 (Aug. 6, 1987) (prepared by the Development Research Group, Inc.) [hereinafter 1987 ICFP Consumer Survey].

54/ See, e.g., Financial Planning Consumers, supra note 35, at 225; see also 1987 IAFP Consumer Survey on Fin. Attitudes, supra note 31, at Table 32 (responses to Q.6E). The respondents to the recent ICFP consumer survey of subscribers to Personal Finance Magazine reported that their expectations for financial planning services were overwhelmingly for investment advice (75%), tax planning (60%), and both general financial advice and retirement planning (56%). 1987 ICFP Consumer Survey, supra note 53, at 3.

financial planner advice. 55/ Table 3 identifies the choices provided by the SEC Special Planner Inspections client outline, the total number of times each choice was marked, the number of times each choice was ranked number one, and the related percentages. Again, it is important to note that the information was derived from client files, not from direct discussion with clients.

55/ These files typically contain a questionnaire or other document provided by the planner to the client for the purpose of eliciting information about the client's investment objectives, background, etc.

Table 3

REASONS WHY CLIENTS SOUGHT THE ADVICE OF FINANCIAL PLANNERS

Reasons clients sought advice	Number Times Answered	%	Number Times */ Ranked One	%
Plan for retirement	396	16.3	238	20.4
Reduce income taxes paid	385	15.9	182	15.6
Plan financial future	310	12.8	191	16.4
Increase net worth	219	9.0	92	7.9
Estate planning	212	8.7	85	7.3
Save for children's education	204	8.4	84	7.2
Increase income	126	5.2	71	6.1
Portfolio management	105	4.3	54	4.6
Help in personal budgeting	96	4.0	49	4.2
Hedge against inflation	92	3.8	23	2.0
Help in saving money	87	3.6	37	3.2
Purchase securities	74	3.1	21	1.8
Purchase insurance	62	2.6	11	0.9
Buy a new residence	34	1.4	18	1.5
Purchase tax shelter investment	21	0.9	8	0.7
Total number of responses	2,423		1164	
Average reasons per client	2.6			

Source: SEC Special Planner Inspections
Item 10 of Client Outline

*/ The total number of times a registrant ranked a reason as "number one" (1164) is greater than the number of registrants sampled (924). The discrepancy arises because some registrants rated more than one reason as "number one".

The three most important reasons for seeking planner advice were retirement planning, reduction of income taxes, and planning for the client's financial future.

The table shows that the purchase of financial products such as insurance, securities or tax-shelters were among the reasons least frequently cited by clients for seeking financial planning help, although clients seeking a "reduction of income taxes" could be regarded as seeking investment in tax-sheltering products. The purchase of products was cited by clients less than 4 percent of the time and was ranked as the most important reason for seeking planner advice by less than 2 percent of planner clients. These rankings suggest that planner clients are seeking planners for financial advice and are not, at least initially, looking to planners as the vehicles through which to buy securities or insurance.

The SEC Special Planner Inspections also directly asked planners to describe their clients' investment objectives. Table 4 discloses their responses.

Table 4

INVESTMENT OBJECTIVES OF CLIENTS

Objective	Number Picking as First Objective	%
Capital growth with some safety of principal	205	25
Capital growth and income	169	20
Preservation of capital	126	15
Tax savings	122	15
Income	122	15
Aggressive growth of capital	81	10
Total	825	

Source: SEC Special Planner Inspections
Item 11 of Client Outline

According to the planners, the most popular client objective (25%) is capital growth with some safety of principal; 20% of clients are seeking capital growth and income; 15% are most concerned with preservation of capital; another 15% are looking to save on taxes; and another 15% are seeking income; 10% are seeking aggressive growth of capital. These answers suggest that, from the planner's perspective also, the client's purposes for seeking financial advice are conservative.

Both the SEC Special Planner Inspections and the recent ICFP consumer survey 56/ also provided information about how clients locate a particular planner. The Inspections provided this information from the planner's perspective. 57/ Financial planners use a variety of methods to attract clients to their planning services and product sales operations. Table 5 shows these various methods and the number of planners and product sales affiliates of planners that reported using or planning to use each method. 58/

56/ 1987 ICFP Consumer Survey, supra note 53.

57/ The Registrant Outline, Item 6 asked the planner to characterize how it attracts clients.

58/ More than one method is used by most planners.

Table 5

HOW CLIENTS ARE ATTRACTED TO FINANCIAL PLANNERS AND THEIR PRODUCTS

	Financial Planner		Product Sales	
	Number Indicating They Use	%	Number Indicating They Use	%
Referrals from clients	65	17	51	15
"Word-of-mouth"	62	16	53	18
Yellow pages listings	53	14	35	10
Referrals from brokers, accountants & others	52	13	38	11
Conducting seminars	37	10	22	6
From product sales clients	31	8	30	9
From non-investment adviser clients	28	7	31	10
Advertising	20	5	21	6
Direct mail	19	5	19	5
Cold calling	10	3	17	8
No attempt to get clients	9	2	4	2
Total number responses	386		346	

Source: SEC Special Planner Inspections
Item 6 of the Registrant Outline

The table shows that the method planners cite most often is "referrals from [existing] clients", with "word-of-south," "yellow pages" listings, and referrals from brokers, accountants and others, the next most popular methods. A very small percentage of financial planners say they rely on advertising other than yellow pages advertising.

Consumers in the recent ICFP survey also cited personal referrals as the most common source of information in finding a planner. The consumers cited referrals from other professionals (lawyers, brokers, etc.) as the most common source of information (48% cited this source), and referrals from friends or family members as another common source (13.7% cited this source). But, while planners surveyed in the SEC Special Planner Inspections did not regard advertising as an important source of getting clients, a fairly large percentage (23%) of planner clients surveyed in the ICFP survey listed advertising as a source of information used in choosing a planner. 59/

7. Consumer satisfaction

The recent survey of financial planning consumers conducted on behalf of the ICFP provides information regarding consumer satisfaction. The survey found that respondents were generally satisfied with their planner: 14% ranked their planner as excellent, 56% as satisfactory, and 21% as unsatisfactory. Table 6, taken directly from the survey, cross-tabulates planner designations and satisfaction.

59/ 1987 ICFP Consumer Survey, supra note 53, at attachment - question #4.

Table 6

CLIENT SATISFACTION AND PLANNER DESIGNATION

Designation	Excellent	Satisfactory	Unsatisfactory
CFP	19%	58%	22%
ChFC*	10%	60%	25%
CLU	6%	79%	12%
CPA	10%	61%	20%
Lawyer*	20%	70%	10%
CFA*	25%	75%	0%

* Should probably not be viewed as statistically valid because of the small number of respondents using these types of professionals as financial persons.

Source: 1987 ICFP Consumer Survey, supra note 53, at 2.

The table shows that both the largest percentage of unsatisfactory marks (22%) and the largest percentage of excellent marks (19%) were given to CFP-planners. Similarly, both the lowest percentage of unsatisfactory (12%) and excellent (6%) marks went to planners who are CLUs.

Table 7, also taken directly from the survey, reports the level of satisfaction in relation to how a planner is paid. Planners compensated by fees alone were marked excellent by 23% (the highest percentage of any type) of their clients and unsatisfactory by 21%. On the other end of the scale, the most unsatisfactory marks (28%) went to those compensated by a combination of fees and commissions.

Table 7

CLIENT SATISFACTION AND PAYMENT METHOD

Payment mode	Excellent	Satisfactory	Unsatisfactory
Fee	23%	54%	21%
Salary*	40%	20%	40%
Commission	12%	64%	22%
Fee & Commission	3%	69%	28%
Don't know	7%	60%	26%

* Should probably not be viewed as statistically valid because of the small number of respondents using this type of professional as financial planner.

Source: 1987 ICFP Consumer Survey, supra note 53, at 2.

8. Summary

A general picture of the typical financial planner clientele emerges from the various sources of information. The typical financial planner client:

* is male, middle-aged,
* is married,
* is working in a business/professional area,
* is reasonably well educated,
* has a relatively high income and net worth,
* is seeking to plan for retirement, or to reduce taxes paid,
* found the planner through referral from another client of the planner.

B. Planner/Adviser Characteristics

The Subcommittee posed the following questions concerning planner/adviser characteristics:

> What are the characteristics of financial planners or advisers? What is (are) their:
>
> size (e.g., the number of employees, customers, offices and states of operation);
>
> background (e.g., their education, experience and qualifications);
>
> other business activities (e.g., are they a broker-dealer, insurance agent, banker, accountant, etc.); and
>
> custody of, or discretionary authority over, client funds and the amount of funds involved?

To respond to these questions, this subchapter is organized into five subsections: 1) Size and structure, 2) Location, 3) Background, 4) Other business activities, and 5) Custody and discretion.

1. Size and structure

A variety of sources suggest that most financial planners either work alone or work in small business organizations. Member surveys conducted by financial planner professional associations disclose that at least half the members work in organizations of ten or fewer employees. 60/ The ADV Database shows that the average number of investment advisory employees for each adviser (including advisers who are financial planners) was 3.1 and for each financial planner was 2.7. The SEC Special Planner Inspections likewise indicate that the financial planning activity is likely to be small, with an average of 2.5 employees. The affiliated product sales firm was identified as being much larger, with an average 6.6 employees.

As for structure, membership surveys and SEC data show that the overwhelming number of financial planner firms are either sole proprietorships or small corporations. Very few are organized as partnerships. 61/

60/ For example, a 1986 survey by the National Association of Personal Finance Advisers (NAPFA) reported that about 80% of the members either were sole proprietors or worked in 1 - 6 person corporations. See NAPFA: Membership/Benefits Survey (June 6, 1986) and analysis (Oct. 13, 1986), with letter from Mary A. Malgoire, President, NAPFA, to Div. of Investment Management, SEC, May 18, 1987 (see response to question 20) [hereinafter 1986 NAPFA Membership/Benefits Survey Results]. A 1986 ICI survey showed that 63% of its associate members (investment advisers not serving as adviser to any fund), reported that they worked as sole proprietors or in firms with 2 - 5 employees. Internal Memorandum of the Investment Company Institute from Mary Walsh to Robert Bunnen, Jr. (Aug. 20, 1986) (presenting results of 1986 ICI Associate Members Survey) [hereinafter 1986 ICI Associate Members' Survey]. A 1986 IAFP member survey showed that 50% of the members worked with 10 or fewer people. Int'l Ass'n for Fin. Planning, Summary, 1986 General Membership Survey 10 [hereinafter 1986 IAFP Membership Survey]. While most planner firms have few employees, there are some very large firms. For example, the 1986 IAFP member survey found that 16% of the members had 11 - 50 employees, 12% had between 50 and 500 employees, and 22% had more than 500 employees. Id. at 10.

61/ For example, a 1986 NAPFA survey reported that 88% of members responding were either sole proprietors (35%) or worked for corporations (53%). 1986 NAPFA Membership/Benefits Survey Results, supra note 60, responses to (continued...)

As will be discussed in more detail below, 62/ financial planners are often involved in some way with the sale of financial products, such as mutual funds, insurance contracts, limited partnerships, or stocks and bonds. The SEC Special Planner Inspections found that 69 of 81 active planners (85%) were affiliated with an organization that sold financial products. The SEC Special Planner Inspections also found that employee time in the inspected firms was devoted more heavily to product sales than to planning. Of the 81 firms and their product sales affiliates inspected, a full-time employee equivalent of 319 professionals were devoted to the sale of products, while 109 were involved in planning. 63/ The 69 firms actively engaged in financial planning used an average of 2.5 people in the planning activity while the related product sales activity involved an average of 6.6 persons.

The number of clients typically served by a financial planner is difficult to count. The number might include all persons for whom the planner had performed any kind of planning service during a year, or might include only those persons for whom the planner had prepared a comprehensive financial plan. The SEC Special Planner Inspections found that in 1986 more than 3,000 persons came to the 81 inspected planners to discuss the possibility of having a financial plan prepared -- an average of 40 per active planner. The SEC 1986 Inspection Report Review

61/(...continued)
Question 20. The American Society of CLU & ChFC determined that 93% of members were either sole proprietors (48%) or owners or employees of corporations (45%). Letter from Burke A. Christensen, Vice Pres. and Gen. Counsel, ASCLU & ChFC, to Div. of Investment Management, SEC (May 6, 1987) (with selected excerpts from ASCLU & ChFC's 1985 membership survey. Percentages herein are extracted from Table 10, T-5 of that survey's result) [hereinafter ASCLU & ChFC 1985 Survey]. The 1986 IAFP member survey found that 90% of the respondents were either sole proprietors (29%) or were associated with corporations (61%). 1986 IAFP Membership Survey, supra note 60, at 10. The SEC Special Planner Inspections found that 99% of the firms were organized either as sole proprietorships (38%) or corporations (61%).

62/ See infra Chapter V.C.2.

63/ In addition, the planning activity of the firms inspected takes place on average at 1.5 separate office locations, but the sales activity takes place on average at 1.9 office locations.

found that, of the 294 planners inspected, the 205 active planners had, among them, 6,854 persons listed as clients, or an average of 33.4 clients per planner. 64/

The literature contains few surveys of client number. The average number of financial planning clients among IAFP members was reported as 175. 65/ A study performed for the ICFP reported that 45% of the planners had fewer than 100 clients, 33% had more than 200 clients, and about 20% had between 100 and 200 clients. 66/

One survey of planners from small cities, derived from listings in the Yellow Pages, 67/ found that the number of clients served by a financial planning firm was inversely related to the educational qualifications of the planners employed by the firm. The survey ascribed point values to the educational backgrounds of each employee of a firm. Only degrees in finance or related fields were assigned values. A bachelor's degree was given a point value of 1, a graduate degree below Ph.D a 2, and a Ph.D. a 3. Firms were then differentiated into two groups, those with an average point score of less than 1, and those with a point score of 1 or more. The survey found that on average the firms in the first group (a point score of less than 1) had 84 clients per financial planner. The firms with a point score of 1 or higher had 52 clients per planner. 68/

2. Location

A review of the literature confirms that financial planners are located near metropolitan areas. A survey of 21,221 IAFP

64/ Not all of the planners are "full time" planners, and some of the clients may have been institutional clients.

65/ 1985 IAFP Membership Survey Results, supra note 29, at 11.

66/ T. Hira, H. Van Auken & D. Norris, A Look Behind the Scenes: A Survey of How CFPs Work 7 J. Inst. Certified Fin. Planners 69, 76 (1986) [hereinafter A Look Behind the Scenes].

67/ Cities generally of a population of 250,000 or less. J. Hilliard, An Interpretative Survey of the State of Professionalism in the Personal Financial Planning Industry, (Fall 1986) (unpublished thesis) [hereinafter Hilliard].

68/ Id. at 44-46. (The analysis did not mention the relative wealth, assets, or nature (institutional or individual) of the clients served by the two groups.)

members conducted in 1985 69/ revealed that thirty-nine percent of the 2,517 respondents were located in metropolitan areas with a population of over 1 million and 21% worked in areas with a population of between 500,000 and 1 million, for a total of 60% of respondents in areas with over 500,000 people. Fifteen percent of the members operate in medium-sized cities (250,000 - 500,000), 19% operate in small cities (50,000 -250,000), and only 7% are in towns under 10,000.

A similar survey among ICFP members also found that financial planners were located in more populous areas. 70/ Approximately half (49%) of those members responding to the survey were located near the large cities or metropolitan areas which they define as their market. Fifteen percent were located in medium-sized cities, while 34% were in small towns and cities. The practice of approximately 95% of the financial planners surveyed was described as local or regional, as opposed to national or international.

A third survey of 14,995 IBCFP registrants from the United States and 22 from 11 other countries (total 15,017) revealed more specific information regarding the geographic distribution of financial planners. 71/ Of the 14,995 registrants located in the United States, the largest number (19%) are located in the state of California, with 37% of the California group located in Los Angeles. The smallest number of CFPs (.1%) are located in the state of Wyoming.

According to the AICPA Personal Financial Planning Division Membership Questionnaire 72/, California also has the largest number of CPAs who do personal financial planning (11.4%). Texas is next with 7.4%, while New York places third with 7%. The fewest financial planning CPAs (.1%) are located in Nevada.

69/ 1985 IAFP Membership Survey, supra note 29, at 8.

70/ A Look Behind the Scenes, supra note 66, at 74.

71/ Int'l Bd. of Standards and Practices for Certified Fin. Planners, IBCFP Registrant Survey Results (June 1987) [hereinafter 1987 IBCFP Survey Results].

72/ American Inst. of Certified Pub. Accountants, Tabulated results of 1986 AICPA Personal Financial Planning Division Membership Questionnaire (attached to letter from John H. Graves, Dir., Technical Information Div., AICPA to Div. of Investment Management, SEC (July 6, 1987)) [hereinafter AICPA PFP Questionnaire].

Another source for geographic location statistics for financial planners is the ADV Database. 73/ As part of the data gathering for this report a comparison was made of the statistics taken from the ADV Database and the financial planner listings in the Yellow Pages throughout the United States. 74/ Table 8 illustrates this comparison. The table shows that although about three times more financial planners list themselves in the Yellow Pages than are registered with the SEC, 75/ the distribution by state as a percentage of the total is practically the same for both sources.

73/ The ADV Database of May 1985 provided this information.

74/ These Yellow Pages listings were compiled by the American Business Lists, Inc. (Mar. 1987).

75/ The disparity in numbers may be accounted for in a number of ways. See supra Chapter III, and infra Chapter V.D.1. for a discussion of the distinction between financial planners who must register with the SEC, and those who need not. See also supra Chapter IV.B., for a discussion of the numbers that comprise the ADV Database. The Database counts firms, not the individuals employed by firms.

Table 8

DISTRIBUTION OF FINANCIAL PLANNERS BY STATE
ADV AND YELLOW PAGES COMPARED

STATE	ADV	%	Yellow Pages	%
AL	41	0.83%	135	0.95%
AK	31	0.63%	65	0.46%
AZ	91	1.84%	324	2.27%
AR	42	0.85%	67	0.47%
CA	664	13.41%	2387	16.76%
CO	129	2.60%	476	3.34%
CT	131	2.64%	295	2.07%
DE	53	1.07%	46	0.32%
DC	68	1.37%	55	0.39%
FL	210	4.24%	708	4.97%
GA	76	1.53%	293	2.06%
HI	23	0.46%	93	0.65%
ID	29	0.59%	78	0.55%
IL	243	4.91%	570	4.00%
IN	135	2.73%	212	1.49%
IA	45	0.91%	153	1.07%
KS	76	1.53%	199	1.40%
KY	51	1.03%	81	0.57%
LA	64	1.29%	197	1.38%
ME	23	0.46%	43	0.30%
MD	115	2.32%	210	1.47%
MA	131	2.64%	456	3.20%
MI	248	5.01%	424	2.98%
MN	121	2.44%	321	2.25%
MS	40	0.81%	105	0.74%
MO	97	1.96%	277	1.94%
MT	25	0.50%	70	0.49%
NE	33	0.67%	88	0.62%
NV	55	1.11%	75	0.53%
NH	50	1.01%	92	0.65%
NJ	191	3.86%	452	3.17%
NM	38	0.77%	90	0.63%
NY	264	5.33%	525	3.69%
NC	56	1.13%	277	1.94%
ND	19	0.38%	47	0.33%
OH	142	2.87%	754	5.29%
OK	51	1.03%	163	1.14%
OR	60	1.21%	248	1.74%
PA	127	2.56%	445	3.12%
RI	29	0.59%	64	0.45%
SC	59	1.19%	118	0.83%
SD	27	0.55%	52	0.37%
TN	58	1.17%	227	1.59%

TX	265	5.35%	808	5.67%
UT	40	0.81%	168	1.18%
VT	21	0.42%	32	0.22%
VA	136	2.75%	323	2.27%
WA	98	1.98%	443	3.11%
WV	34	0.69%	52	0.37%
WI	83	1.68%	317	2.23%
WY	15	0.30%	43	0.30%
TOTAL	4953	100.00%	14243	100.00%
AVERAGE	125.47		279.27	

Source: SEC ADV Database and compilation of the Yellow Pages by American Business Lists, Inc. (Mar. 1987)

3. Background

This subsection describes the demographics, educational background, experience, and qualifications of planners.

a. Demographics

Surveys in the literature provided the only information about the age and gender of financial planners. It is safe to say that no matter who conducted the survey, or how the results were tabulated, financial planners were shown to be overwhelmingly male and roughly middle-aged.

First, regarding gender: A survey of ICFP members is typical. It reported that 78% of ICFP respondents were male. 76/ Similarly, the 1986 IAFP membership survey reported that 83% of IAFP members were male. 77/ The American Society of CLUs and ChFCs reported that 97% of the Society's respondents were male. 78/

As for age, most financial planners are middle-aged, as that term is loosely defined: For example, the average age of IAFP members responding is reported to be 42 years. 79/ A more recent survey conducted by the IBCFP found that 75% of the respondents

76/ A Look Behind the Scenes, supra note 66, at 71-72.

77/ 1986 IAFP Membership Survey, supra note 60, at 2.

78/ ASCLU & ChFC 1985 Survey, supra note 61, Table 64 at T-26, T-28. Other surveys report similar results: 79% of the respondents to the NAPFA Survey are male, 1986 NAPFA Membership/Benefits Survey Results, supra note 60; 90% of the members of the newly formed AICPA Personal Financial Planning Division are male, AICPA PFP Questionnaire, supra note 72.

79/ 1986 IAFP Membership Survey, supra note 60, at 2.

were in their 30s and 40s. 80/ The average respondents' age of the American Society of CLUs and ChFCs was 46 years: 28% were in their 30s, 30% in their 40s, and 24% in their 50s. 81/

b. Education

There are no federal testing requirements, minimum education requirements, or continuing education requirements applicable to advisers or financial planners per se. 82/ Nevertheless, as discussed below, most financial planners have at least a college degree.

A number of surveys in the literature discuss the educational background of planners. Membership surveys conducted by professional associations show that their members (or member employees) are overwhelmingly college educated. For example, an IAFP survey reported that 82% of the IAFP respondents held a college or higher degree. 83/ An ICFP member survey reported

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80/ 1987 IBCFP Survey Results, supra note 71. The IBCFP reported the following numbers:

Age Category	Responses
Under 20	1 - .02%
20-25	31 - .9%
26-30	294 - .7% [sic]
31-39	1300 - 38.5%
40-49	1217 - 36.0%
50-59	318 - 9.4%
60 & over	213 - 6.3%

81/ ASCLU & ChFC 1985 Survey, supra note 61, at T-26, 28. Other surveys report similar results: the NAPFA Membership/ Benefits Survey Results, supra note 60, found that 97% of the respondents were in their 30s, 40s or 50s; the AICPA PFP Questionnaire, supra note 72, reported that 63% of the Division members were between 36 and 55 years of age. Finally, the survey of NALU planners found that the median age was 42 years. 1985 NALU-LIMRA Survey, supra note 30, at 4.

82/ Financial planners who are registered representatives of broker-dealers must pass a qualifying examination. See infra Appendix B.

83/ 1986 IAFP Membership Survey, supra note 60, at 2.

that 83% had a college or higher degree. 84/ The American Society of CLU & ChFCs reported that 78% of Society respondents had at least bachelor's degrees, and that an additional 14% had attended college; 5% did not have education beyond high school. 85/ Finally, a survey of the AICPA's Personal Financial Planning Division members found that 95% had at least a bachelor's degree, and 38% had finished graduate study; only 5% had attended college but had not received a degree. 86/

One survey from the literature that included a cross-section of financial planners rather than only planners who are members of a professional association, reported a somewhat lower percentage of planners with college or higher degrees. This survey of financial planners listed in the Yellow Pages from communities with populations of less than 250,000 estimated that only 62% of the respondents had earned a bachelor's or higher degree. 87/

Similarly, the SEC Special Planner Inspections reported planners achieving a lower level of education than the education level reported for the professional association members. Out of a total of 116 financial planning employees surveyed, 71% had earned at least an undergraduate college degree; 15% had some college education, 8% were high school graduates, and 6% had not completed high school. The 319 non-clerical employees that engaged in product sales were reported to have similar levels of education: 66% had at least undergraduate degrees; 20% had some college experience; 10% were high school graduates; and 4% had not finished high school.

The survey results, even of planners not belonging to professional associations, point to a relatively well-educated industry. It is important to note, however, that there is little information concerning the extent to which financial planners are specifically educated to engage in financial planning. A few surveys, most notably the Yellow Pages survey mentioned above,

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84/ A Look Behind the Scenes, supra note 66, at 72. More specifically, 51% had a bachelor's degree, 27% had a master's degree, 5% had education beyond a master's degree, and 16% did not have education beyond high school.

85/ ASCLU & ChFC 1985 Survey, supra note 61, Table 65 at T-26.

86/ AICPA PFP Questionnaire, supra note 72.

87/ Hilliard, supra note 67, at 41, 43.

have some data on specific educational credentials, 88/ but there is little hard data on the subject.

c. Experience

The information that exists concerning the experience of financial planners suggests that many planners, perhaps even a majority, are fairly new to the planning business. The one exception is a survey of American Society of CLU and ChFC members, which reported that members were in the planning business for an average of 19 years with only 16% of the members having less than 10 years experience. 89/ A survey of NALU members showed that financial planning agents had an average of 8 years of experience in the planning business and had been in their current positions for 5.5 years. 90/ A survey of NAPFA members showed that 75% had been planners for less than 10 years. 91/ Finally, a survey of California financial planners listed in the Yellow Pages showed that half were in the planning business for less than 10 years. 92/

88/ Id. That survey reported that of the 44% of the respondents who had earned at least a bachelor's degree, half (22%) had earned degrees that were finance related, of the 12% who had also earned at least a masters degree, three-fourths (9%) had earned finance related degrees, and of the 3% who had earned a Ph.D., two thirds (2%) had earned finance related degrees. Id. at 43.

89/ ASCLU & ChFC 1985 Survey, supra note 61, Table 66, at T-27. The relatively greater experience of members of this society comports with the criteria for achieving a CLU or ChFC designation. See Appendix D.

90/ 1984 NALU-LIMRA Survey, supra note 43, at 3.

91/ 1986 NAPFA Membership/Benefits Survey Results, supra note 60, at 2.

92/ The California Department of Corporations sent surveys to all businesses listed in three categories from the Yellow Pages in the State of California: financial planners, investment advisers/investment advisory services, and investment management. Banks and Savings and Loan institutions were excluded because they are exempt from the statutory definitions of broker-dealer and investment adviser under the California securities law. Questionnaires sent out totaled 2,650; 961 were returned. State of California, Dep't of Corporations, Dep't of Corporations' Fin. Planner Survey Results 5 (Oct. 5, 1984) [hereinafter Cal. Dep't of (continued...)

Another possible indication of the relative inexperience of planners comes from a review of all SEC inspection reports of planner advisers for the year 1986 (the SEC 1986 Inspection Report Review). Of the 294 planners inspected, 96% had been registered only since 1982, while 72% or 211 had been registered as advisers for two years or less. These results portray a somewhat biased profile, however, to the extent that the SEC deliberately targets new advisers for inspection. 93/

d. Qualifications

While there are no federal qualification standards for investment advisers or financial planners, 26 states require investment advisers or investment adviser representatives to pass a test before they can register. 94/ There are also a number of financial planner professional associations, 95/ and some of these are limited to planners who pass a qualifying examination. For example, to become a Certified Financial Planner, a candidate must meet certain education and experience requirements, and must pass a series of qualifying examinations. The ICFP is a voluntary membership organization for financial planners who are CFPs

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92/(...continued)
Corp. Survey].

93/ For a discussion of the SEC's inspection program, see infra Chapter V.E.

94/ 2 Investment Company Institute, Investment Advisers Guide (1987). The examinations required are usually those required for broker-dealers or registered representatives, and often include the Uniform Securities Agent State Law Examination. Examination by the states is likely to continue to grow: the North American Securities Administrators Association's ("NASAA") Model Amendments to the Investment Adviser Provisions of the Uniform Securities Act of 1956 (Nov. 20, 1986) have added in Section 204(b)(6) the power for a state securities administrator to require an investment adviser state-law examination. The examination has been written, and NASAA is now preparing to establish a means for the states to administer it.

95/ The number of associations is growing rapidly. Each association promotes the association's own definition of financial planning and imposes ethical guidelines. Heffernan, Association Overload, Financial Planning, October 1986, at 100. A glossary of terms, including financial planner trade and professional associations, is provided in Appendix D.

(or who are candidates to be CFPs); it has approximately 8,500 members. 96/ An independent review board known as the IBCFP grants and revokes the CFP designation. A similar situation occurs in the insurance industry with the Chartered Life Underwriter (CLU) and Chartered Financial Consultant (ChFC) designation, which require the candidate to complete ten courses offered by the American College in Bryn Mawr, Pennsylvania. When the candidate has met the education and examination standards, shown three years of relevant experience, and met ethical standards, the American College will grant the designation. These designations qualify their holders to join the American Society of CLU, a membership organization.

The Chartered Financial Analyst ("CFA") designation is awarded by the Institute of Chartered Financial Analysts, which administers the three examinations for the designation. In addition to the requirement to pass all three tests, candidates must have had three years of experience, and comply with a code of ethics and standards of professional conduct. The affiliated Financial Analysts Federation ("FAF") is a membership organization composed of investment managers and securities analysts who have passed at least the first CFA examination and are members of one of the 57 affiliated chapters and societies. The Code of Ethics and standards of professional conduct are identical to that of the Institute and both organizations have disciplinary programs that cooperate for joint members. The Institute has chartered 10,000 individuals as CFA's, and the Financial Analysts Federation lists 16,000 members. 97/

The Registry of Financial Planning Practitioners is administered by the International Association for Financial Planning. The Registry requires that candidates be in financial planning practice for three years, possess a CFP, ChFC, CPA, JD, LLM or a bachelor's degree in business, pass a practice knowledge examination, provide references from five clients that have used the planner for two years and had a plan prepared, and submit a sample plan prepared for clients for review. NAPFA, one of the newer financial planning organizations, limits membership to fee-only planners. It is reported to have 160 members. 98/

96/ Telephone interview with Brent A. Neiser, Director of Education and Professional Development, ICFP (Feb. 11, 1988).

97/ Morley, What's So Special About a CFA?, Pension World, Sept. 1985, at 50.

98/ CFA Report, supra note 16, at 20.

As disclosed in professional association member surveys, 99/ a Yellow Pages survey conducted by the California Department of Corporations, and in data from the SEC Special Planner Inspections, many financial planners are members of several professional associations and have a number of professional qualifications in addition to those specifically tailored to financial planning. For example, the Yellow Pages survey determined that 55% of those listed as financial planners were also insurance brokers; 48% were IAFP members; 25% were ICFP members; 25% had real estate licenses; 6% were CPAs; 4% were attorneys; and only 15% claimed no memberships and no other professional qualifications. 100/ The IAFP's 1986 general membership survey disclosed that 70% of the respondents were licensed life insurance agents; 60% were licensed health insurance agents; 31% were CFPs; 19% were licensed real estate agents; 20% were CLUs; 17% were ChFCs; 13% were CPAs; and 5% were attorneys. 101/

The SEC Special Planner Inspections requested specific information on the professional qualifications of individuals who provide financial planning and of individuals engaged in product sales as affiliates of financial planners. Table 9 lists the indicated professional qualifications of the 116 non-clerical employees of the 81 active planners and of the 111 employees of the related product-sales organizations:

99/ Surveys have been conducted by the IBCFP (1987 IBCFP Survey Results); the Financial Analysis Federation (FAF Membership Survey: Interpretive Report I-19 (conducted by Opinion Research Corp. for FAF, ORC Study #64123) (Aug. 1985) [hereinafter FAF Membership Survey]); IAFP (1986 IAFP Membership Survey); and the AICPA's Personal Financial Planning Division (AICPA PFP Questionnaire, 1986). They all show members with multiple affiliations and qualifications.

100/ Cal. Dep't of Corp. Survey, supra note 92, at 1, 5.

101/ 1986 IAFP Membership Survey, supra note 60, at 2.

Table 9

PROFESSIONAL QUALIFICATIONS OF EMPLOYEES

	Financial Planner		Product Sales	
	Number Indicating They Have	%	Number Indicating They Have	%
Certified Financial Planner	37	26	33	25
Chartered Life Underwriter	27	19	23	18
Chartered Financial Consultant	21	15	13	10
Registry of Financial Planning Practitioners 102/	20	14	15	11
Attorney	16	11	12	9
Certified Public Accountant	14	10	8	6
Chartered Financial Analyst	4	3	2	2
Public Accountant	2	1	2	2
Chartered Property and Casualty Underwriter	2	1	1	18
Total professional qualifications held	143		109	

Source: SEC Special Planner Inspections
Item 10 of the Registrant Outline

102/ The IAFP has established "The Registry of Financial Planning Practitioners." This is a special listing of IAFP members that are actively engaged in financial planning that have met certain qualifications. See Appendix D.

The CFP designation was the most dominant professional qualification of planners and product sales employees, held by 26% of the planner employees and 25% of the product sales employees. The CFP designation appears to be developing as the most recognized designation in the planning field. The next most prevalent designation, CLU, was held by 19% of the planner employees and 18% of the product sales employees. The relatively large number of persons holding the CLU designation indicates the extent to which life insurance agents have sought to broaden their advisory activities by rendering advice about securities investments, including investments in variable annuities.

The 116 non-clerical planner employees of the inspected firms held a total of 143 designations, which means that a number of persons held more than one designation.

4. Other business activities

Because the term "financial planning" covers a broad spectrum of activities, there are no easy boundaries which allow demarcation of those business activities undertaken by financial planners that are different from, or "other" than, financial planning activities. A planner may also provide accounting services or give legal advice as an attorney, but those activities would form an integral part of the planner's planning business. To illustrate, consider a survey of IAFP members. The survey showed that the so called "business functions" of the respondents fell into the following categories: 103/

financial planner:	41%
executive/manager:	11%
insurance agent/ broker:	8%
accountant:	8%
sales/marketing representative:	7%
account executive/ stockbroker:	6%
investment counselor/ asset manager:	3%

103/ 1986 IAFP Membership Survey, supra note 60, at 3.

The most meaningful question regarding the "other business activities" of financial planners, then, is not whether they perform planning services that are not strictly financial planning services, but whether they engage in business activities outside the realm of planning. The surveys reported in the literature, the data from the ADV Database, the SEC Special Planner Inspections, and the SEC 1986 Inspection Report Review suggest that selling financial products, rather than only giving advice about them, is a significant "other business" of financial planners.

A random survey of financial planners taken from the California Yellow Pages, for example, disclosed that the largest number of respondents (62%) sold securities to their clients, 55% were licensed insurance brokers or agents, and 20% sold real property to their clients. 104/ A survey of thirty Washington, D.C. financial planners, performed as part of a study by the Consumer Federation of America, reported that 93% were licensed to sell insurance and/or securities, or worked with someone who was so licensed. 105/ A survey limited to small cities and based on Yellow Pages listings of financial planners, reported that approximately 90% of the planners sold securities as part of plan implementation. 106/ Finally, a 1984 NALU survey found that 98% of the financial planning NALU agents whose primary companies offered individual life policies, actually sold that product. Of that group, 56% placed the business exclusively with the primary company and 43% placed it with the primary company and others. Products found to be most frequently placed with the primary company were variable life policies, money market funds, mutual funds, and tax shelters. 107/

The ADV Database also indicates that selling financial products is an important part of an adviser's business activity. The data show that more than half (56%) of the advisers who regard themselves as financial planners are affiliated in some way with broker-dealers, and more than one third (38%) are affiliated with insurance companies or agencies. The SEC 1986 Inspection Report Review yielded similar results. Of the 294 planners inspected, approximately 214, or 73%, were either dually registered as advisers and broker-dealers, or were registered

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104/ Cal. Dep't of Corp. Survey, supra note 92, at 1, 2.

105/ CFA Report, supra note 16, at 16.

106/ Hilliard, supra note 67, at 45.

107/ 1984 NALU-LIMRA Survey, supra note 43, at 5-6.

representatives of broker-dealers. Thirty-five, or 12%, were registered to sell life insurance products to their customers.

The SEC Special Planner Inspections also collected data on other businesses of planners. As part of the inspections, planners were asked to describe other types of business activities performed by persons or affiliated sales organizations. Table 10 shows the results.

Table 10

OTHER TYPES OF BUSINESS ACTIVITIES

	Financial Planning Organization		Affiliated Product Sales Organization	
	Number Engaging in	%	Number Engaging in	%
Insurance sales	41	51	56	81
Tax advising	37	46	17	25
Securities brokerage	31	38	57	83
Pension consulting	22	27	17	25
Teaching	15	18	11	16
Accounting	12	15	4	6
Real estate sales	11	14	11	16
Legal	7	9	4	6
Commodity sales/advising	3	4	4	4

Source: SEC Special Planner Inspections
Item 22 of Registrant Outline

The importance of product sales, whether conducted by the planner organization or affiliated product-sales organization, was revealed. Forty-one, or 51%, of the financial planning organizations also sold insurance, 38% engaged in securities brokerage, and 14% sold real estate. Fifty-seven, or 83%, of the affiliated product-sales organizations were engaged in securities brokerage, 81% sold insurance, and 16% sold real estate.

The data, then, suggest that product sales form an important, perhaps integral, part of the business of financial planners.

5. Discretion and custody

Two areas of potential concern regarding investment advisers and financial planners are whether they exercise discretion over the securities transactions of their clients, or have custody of client funds or securities. A planner with investment discretion has the permission of the client to make securities trades without prior approval. Investment discretion poses some risks to the client because the adviser or planner could make trades inconsistent with the client's investment objectives. However, clients normally get written confirmation notices for all trades and periodic statements showing the securities bought and sold for the account and those in the account at the end of the period. A planner can also be given discretion to choose brokers or determine commissions. The potential risk to the client in those instances is that the planner could choose a broker on some basis other than the quality of service rendered to the client. A planner who has "custody" of client funds or securities either holds them outright, or has authority to obtain possession of them, or has the ability to appropriate them. Giving custody to a planner poses the risk to the client of theft or loss of the funds or securities.

An FAF survey of membership found that 59% of members had some responsibility for managing or administering funds. Half of those members managed less than $100 million in funds, more than a quarter managed between $100 and $500 million, and almost a fifth managed more than $500 million. 108/ While the ICI's 1986 adviser membership survey did not measure the proportion of members with discretion over or custody of client funds, it did gauge the assets under management by each member. About 26%

108/ FAF Membership Survey, supra note 99, at I-15. The percentage of FAF members with investment discretion over customer accounts is higher than for planners generally, because FAF members are typically portfolio managers and not planners.

managed less than $10 million, 28% managed $10-50 million, 21% managed $50-100 million, 14% managed $100-300 million, and almost 12% managed over $300 million. 109/

The ADV Database provided investment discretion data on all advisers who are registered with the SEC. As of the close of business September 30, 1987, about 32% of all advisers said they had investment discretion, and managed $2.0 trillion in 5.5 million accounts. However, only about 10% of planners said they had investment discretion, and managed $215 billion in 107,000 accounts. About 28% of all advisers said they provide non-discretionary management, and managed $1.6 trillion in 10.9 million accounts. Approximately 20% of all planners said they provide non-discretionary management and managed $541 billion in 438,000 accounts. Twenty-six percent of all advisers said they had discretion to choose brokers, and 42% of the advisers, because of their dual role as registered representatives, said they had discretion to determine commission rates that are paid. In contrast, ten percent of all planners said they had discretion to choose brokers and to determine commission rates that are paid.

The SEC 1986 Inspection Report Review found that of the 294 planners inspected, 109, or 37%, managed client assets on either a discretionary or non-discretionary basis. The amount under management totaled $225.9 million, or an average of $2,073,000.

The ADV Database provided the only information as to custody of client funds or securities. It shows that about 3% of all advisers have direct custody of $917 million of client funds or securities. Similarly, 3% of all advisers have custody of an additional $1.2 billion in customer funds or securities through a related person. Broker-dealers are the most frequent (about 50%) "related person" to have custody for advisers.

6. Summary

Most planning firms are small, registered in one state, located in more populous areas, serve the immediate locale and also sell insurance or securities. The average individual planner is male, middle-aged, a college graduate and has a background in or is currently providing insurance, securities, or tax/accounting services. The degree of professional experience among financial planners varies widely. Few planners or advisers have custody of client funds.

109/ 1986 ICI Associate Members' Survey, supra note 60.

C. Compensation of Planners/Advisers

Under this heading, the Subcommittee asked the following questions:

> Is the financial planner/adviser compensated for services by a flat fee or by a commission?
>
> If compensation is by commission, what is the type and number of products offered, and what level of disclosure do planners/advisers provide concerning their interest in products they sell -- financial or otherwise?

To respond to these questions, this subchapter is organized into discussions of Compensation, Products Sold, and Disclosure.

1. Compensation

As discussed below, fee-only planners constitute a small segment of the overall planner community. Most financial planners receive at least a portion of their income from sales commissions. In one Yellow Pages survey of financial planners, more than 70% of the respondents reported that they were compensated either by fees and commissions or by commissions only. 110/ In another Yellow Pages study, one limited to small population centers, most respondents, 85%, reported earning at least part of their income through commissions, 72% earned more than half of their income through commissions, and 16% earned their total income through commissions. 111/ Only 11% earned more than half of their income through fees. 112/ Similarly, in a small survey of financial planners in Washington, D.C., conducted by the Consumer Federation of America ("CFA"), only 1 of the 30 surveyed planners was paid a salary and only 2 were fee-only planners whose plan implementation did not include selling products to clients from which commissions were earned. 113/ The CFA study found that, in general, planners who sold products almost always earned the majority of their income from

110/ Cal. Dep't of Corp. Survey, supra note 92, at 2. The survey was of financial planners identified in the California yellow pages.

111/ Hilliard, supra note 67, at 33.

112/ Id. at 33.

113/ CFA Report, supra note 16, at 16, 18.

commissions on the sale of products to implement the financial plan. 114/ Most of the financial planners interviewed by CFA charged a fee in addition to being compensated by commissions. The fee was most often based on an hourly rate (primarily in the $65 to $90 an hour range). Flat fees, the next most common method of compensation, ranged from $250 for a computerized plan to $10,000 for a plan for a wealthy client with substantial, complex investment assets. Four of the thirty planners surveyed were compensated according to a percentage of client income or assets. 115/

Two recent IAFP studies, one of consumers, the other of IAFP members, also reflect the importance of sales commissions to the financial planning industry. More than one-third (35%) of the consumer-respondents reported compensating their planners through commissions only, and an additional 14% reported paying both commissions and fees; 36% paid only a flat fee or an hourly rate; 15% were unsure. 116/ Similarly, a majority of IAFP respondents reported that they relied, at least in part, on commissions for their income: 68% relied on a combination of fees and commissions, salaries and commissions, or on commissions only; 11% were salaried employees; 10% were fee-only planners; and 10% earned a salary plus bonus. 117/

Surveys of other member organizations or consumers likewise show commissions to be an important means of compensating financial planners. As of June 1987, 70% of the CFP registrants were compensated by fees and commissions, or commissions only. 118/ A 1986 ICFP study reported that 70% of financial planners responding received at least 75% of their compensation from

114/ Id. at 17.

115/ Id. at 18.

116/ 1987 IAFP Consumer Survey on Fin. Attitudes, supra note 31, at Table 36 (responses to Q.6I).

117/ 1986 IAFP Membership Survey, supra note 60, at 3. A "bonus" may well be another form of commission. Recent stories have appeared in the press regarding the use of non-cash bonuses such as "exotic vacations and fancy gifts" to reward mutual fund salespeople for sales of featured funds. See, e.g., Quinn, Sponsors Are Sweetening the Pie for People Who Sell Mutual Funds, The Wash. Post, Aug. 17, 1987 (Business).

118/ 1987 IBCFP Survey Results, supra note 71, at 1.

commissions. 119/ And consumers who responded to a survey of Personal Finance Magazine subscribers reported the following means by which they compensated their planner: 37% paid fees only, 32% paid commissions only, and 11% paid both fees and commissions. Sixteen percent of the respondents did not know how they compensated their planner. 120/

Data from the American Society of CLU & ChFC also suggest that planners are very dependent on commission income. Only 14% of the respondents had a flat retainer fee relationship with their clients; only 33% charged professional fees for their services. 121/

The ADV Database's information on financial planner compensation showed that planners who are registered investment advisers seem to be less commission dependent than financial planners included in the Yellow Pages and other professional association surveys. Table 11 shows the percentage of advisers that receive the various types of compensation.

119/ A Look Behind the Scenes, supra note 66, at 74-75.

120/ 1987 ICFP Consumer Survey, supra note 53, at 2.

121/ ASCLU & ChFC 1985 Survey, supra note 61, at T-6 (Tables 15 and 16).

Table 11

COMPENSATION OF ADVISERS

	Financial Planners	Non-Planners	All Advisers
Hourly charges	74%	19%	50%
% of assets under management	28%	76%	46%
Fixed fees	54%	23%	41%
Commission	37%	8%	24%
Other benefit	9%	10%	10% 122/

Source: ADV Database

122/ A small number (9%) of the advisers reported that, in addition to fees charged to clients, they also receive cash or some other economic benefit from non-clients in connection with giving advice to clients. This additional compensation arrangement was used by 14% of the financial planners, 6% of the discretionary investment managers, and 10% of the non-discretionary managers. In addition, 10% of all advisers pay fees to other persons in return for client referrals. Of that sub-group of advisers that pay referral fees, the practice is most prevalent among discretionary money managers. Nineteen percent of the discretionary managers pay referral fees, while just 9% of the non-discretionary managers and planners make such payments. As discussed below, the SEC has rules concerning the disclosure to clients of the payment of these so-called cash solicitation fees. See infra Chapter V.C.3.

An adviser often allows a client to choose from the several offered methods of payment for planning services. As shown in Table 11, non-commission charges to clients are usually on an hourly basis. Seventy-four percent of planner/advisers used or made available this fee arrangement. Fixed fees is the second most common method of non-commission compensation, made available by 54% of the financial planners.

Table 11 shows that only 37% of advisers who are also financial planners reported that they used or made available a compensation arrangement based on commissions. This percentage is substantially lower than the percentages reported in the surveys found in the literature. The SEC has no hard data to explain this difference. The probable explanation is that many advisers responding to the compensation question on Form ADV only identified their means of compensation for performing advisory services. If they also sold products pursuant to some other identity, for example, a broker-dealer or insurance agent, they did not regard that income as compensation for their advisory services.

The SEC Special Planner Inspections provided the most detailed breakdown of compensation methods for financial planners. Planners who charged a fee for preparing an initial financial plan for their clients earned a total compensation of $745,000, which averages $13,314 per respondent in 1986. The same group reported receiving a total of $2,064,000 for all fee-based advisory activities, or an average of $37,500 per planner, excluding commission income and income earned from other business activities. The source of this additional $24,200 of income was the preparation of follow-up plans, or consultations and other advisory services for which an hourly or flat fee was charged. 123/ In contrast, the total amount of fees, commissions and other compensation received by the sales affiliates from product sales to all clients (not only those receiving financial plans) was $109,413,000, which averages $1,519,631 per respondent.

Planners inspected in the SEC Special Planner Inspections were found to have charged clients for services rendered in a variety of ways. Table 12 shows the number and percentage of

123/ Planners in the SEC Special Planner Inspections reported that during 1986, on average, they prepared a second complete or partial plan for an additional 18 clients, and had consultations with 23 clients that did not involve the preparation of a plan or the sale of products.

planners using the various methods listed. A planner could report using more than one method. 124/

Table 12

HOW PLANNERS ARE COMPENSATED

	Number Answering	Percent of Planners
Hourly charges	44	54
Fixed fees for plan & consultation	35	43
Fixed fees for a plan	31	38
Percent of assets managed	13	16
Commissions only	10	12
Percent of client income	7	9
Percent of client assets	4	5
Fixed fees less commissions	3	4
Subscription fees	1	1
Total responses	148	
Average	1.8	

Source: SEC Special Planner Inspections
Item 21 of Registrant Outline

124/ The SEC Special Planner Inspections did not capture data on the percentage of planners for whom commissions on sales were one means, but not the exclusive means, of compensation.

The table shows that 54% of the planners charged for their services on an hourly basis while 43% charged a fixed fee for plan preparation and related consultations. Many planners maintain several fee arrangements and allow each client to choose the most suitable fee arrangement. For example, a prevalent combination requires clients to pay a fixed fee for a plan and then to pay hourly charges for any consultations that take place after delivery of the plan.

The SEC Special Planner Inspections data show that each client paid, on average, $1,375 for his financial plan; the median amount was $500.

The Inspections also found that 82% of the financial planner/advisers who recommended mutual funds and variable annuities to clients as part of the financial plan were compensated through direct sales loads. The remainder (18%) were compensated through "12b-1" fees. 125/ Only a very small portion of advisers do not receive any commissions or other types of remuneration from products they recommend or sell. Again, a significant statistic regarding the compensation of inspected planners is that 69 of the 81 planners inspected, or 85%, are engaged in product sales either directly or through affiliates.

2. Products sold

a. In general

The SEC Special Planner Inspections sought information on the types of products sold to planner clients. To obtain this information, inspectors reviewed the products purchased by each of the 924 clients who comprised the sample of clients reviewed for the Inspections. The inspectors found that these 924 clients purchased 322 different mutual funds, 264 different limited partnerships, and 96 different types of insurance products, as

125/ Rule 12b-1 under the Investment Company Act, 17 C.F.R. § 270.12b-1 (1987), permits mutual funds to use fund assets to finance distribution of their shares, provided a number of conditions intended to protect fund shareholders are met. A fund is subject to the rule if it uses fund assets for, among other things, advertising compensation of underwriters, dealers and sales people, the printing and mailing of prospectuses to non-shareholders, and the printing and mailing of sales literature. Although 12b-1 fees are used to pay for sales and promotional expenses, they are not considered "sales loads," as that term is defined in the Investment Company Act, because 12b-1 fees are paid out of fund assets, rather than directly by investors.

well as a variety of other equity, debt, municipal and government securities. 126/ The total cost of products purchased by these clients was almost $38 million, which averages about $52,000 per product.

The Inspections also sought information regarding the overall importance of the sale of each type of product to the business of the planner or to the product sales organization affiliated with the planner. It found that of the 69 inspected planner/sales affiliate organizations that sold products, 58, or 84%, sold mutual funds, 56, or 81%, sold real estate limited partnerships, and 53, or 77%, sold term life insurance. On the other hand, only about half of the planner/affiliates sold United States Government securities, or exchange and NASDAQ-traded equity securities. 127/

One other statistic from the SEC Special Planner Inspections helps depict the nature of the product sales activity of planner affiliates. The planners were asked to list their top three income producing products: of the 69 organizations selling products, 47, or 68%, reported that the sale of mutual funds was

126/ SEC Special Planner Inspections, Item 1 of Product Outline. In all, the 924 clients purchased 724 different products from the sales organizations affiliated with the inspected planners during 1986.

127/ SEC Special Planner Inspections, Item 24 of Registrant Outline. The tabulated results are:

Product type	Number selling to clients	Percent
Investment cos. other than var. ins. prods.	58	84
Real est. lim. ptnerships.	56	81
Term life insurance	53	77
Univ. & variab. life ins.	52	75
Disability ins.	50	72
Other lim. ptnership. interests	43	62
Variable annuities	36	52
Equity securities other than lim. ptnerships. or mutual funds	36	52
Fixed annuities	35	51
U.S. Govt. securities	35	51

in the top three, and 41, or 59%, put the sale of real estate limited partnerships in the top three. 128/

b. Limited partnerships

The information regarding the sale of limited partnership interests is perhaps the most important information gained from the Special Inspections. The recommendation to clients that they purchase limited partnership interests distinguishes financial planner investment advisers from the more traditional investment advisers. These investments may pose a greater risk to clients than more traditional investments because the disclosures made about them may be less comprehensive than for other securities, 129/ or because limited partnership interests are more likely to be illiquid than are shares of stock in publicly traded companies, 130/ or because some limited partnership interests involve business ventures that are highly speculative. One feature of many limited partnership investments that accounts for at least some of their past appeal -- that they have been regarded as good tax shelters -- may no longer pertain following the Tax Reform Act of 1986. 131/

128/ These results are consistent with a survey of broker-dealers performed by Financial Planning in 1985. The survey reported that, in 1985, five large financial planning-oriented broker-dealers paid more than half of their total compensation out of mutual fund sales and ten paid more than half of their commissions through limited partnership sales. Veres, Who's Who in Planning, Fin. Planning, June 1987, 84, at 86.

129/ Limited partnership interests are often exempt from many of the disclosure requirements of the Securities Act of 1933.

130/ Liquidity concerns the ability of someone owning an investment to convert the investment into cash. Usually liquidity depends on the availability of other purchasers for the product. Limited partnership interests tend to be illiquid because there are usually "thin" or no markets for resale. Thus these interests either cannot be resold at all, or can be resold only at a substantial loss.

131/ The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended at 26 U.S.C. § 1 et seq.). As discussed above, an important reason for seeking advice from a financial planner is tax avoidance. See supra Chapter V.A.6. and Table 3.

Regarding liquidity and risk, Item 7 in the product outline of the SEC Special Planner Inspections asked for information about the liquidity of limited partnership interests sold to planner clients as described by the offering circulars for such interests. Table 13 gives the results.

Table 13

LIQUIDITY OF LIMITED PARTNERSHIP INTERESTS
SOLD TO PLANNER CLIENTS

	Number	%
Illiquid: no secondary market	156	66
Somewhat liquid: limited secondary mkt.	64	27
Liquid: good secondary market	17	7
TOTAL	237	100

Source: SEC Special Planner Inspections
Item 7 of Product Outline

As Table 13 shows, only 7% of the limited partnership interests sold to clients were regarded as liquid in the offering circulars used to sell them. The SEC Special Planner Inspections found that the average expected life of the limited partnership interests sold to clients was almost 17 years. 132/

Limited partnership investments may also present a risk of loss of the capital invested. Table 14 summarizes the degree of risk of the limited partnership interests sold to clients, as stated in the offering circulars for those interests.

Table 14

DEGREE OF RISK IN LIMITED PARTNERSHIP INTERESTS SOLD TO PLANNER CLIENTS

	Number	%
Speculative with a high degree of risk	105	44
Moderate risk	87	36
Low risk	29	12
No risk statement given	20	8
Total	241	

Source: SEC Special Planner Inspections
Item 6 of Product Outline

132/ Limited partnership offering circulars usually estimate the life of the limited partnership by stating the year the general partner expects the partnership's assets to be sold or to stop generating income.

The table shows that 44% of the limited partnership interests sold were regarded by their issuer as speculative with a high degree of risk, 36% were regarded as moderately risky, and 12% were described as low risk. No specific risk statement was given for 8% of the offerings.

3. Disclosure

The disclosures a financial planner must make about its interest, financial or otherwise, in the products it sells depends on whether the planner is an investment adviser under the Advisers Act. Those that are not may nonetheless be subject to disclosure obligations as insurance agents or intrastate advisers, and must also avoid committing common law fraud, but they are not subject to the specific statutory disclosure obligations found in the Advisers Act. The following discussion is limited to investment adviser disclosure. The first part of the discussion will briefly summarize the disclosures mandated by the Act; the second part will discuss results of a survey of disclosures actually made on Forms ADV filed with the SEC by a sample of advisers; the third part will discuss disclosures required of broker-dealers executing trades for customers.

a. Advisers Act disclosure requirements

(1) Section 206

As discussed below, 133/ every adviser, including those exempt from registration under the Advisers Act, are subject to the requirements of the Act's antifraud provisions, which are found in Section 206 and the rules thereunder. To summarize here, paragraphs (1), (2) and (4) of Section 206 are general anti-fraud provisions. Paragraph (3) requires specific disclosure to the client whenever the adviser acts as a "double agent" in an agency cross transaction, or is a principal (i.e., sells securities to or buys securities from the client) in transactions with the client. Compliance with paragraph (3) of Section 206 does not relieve advisers from the more general disclosure obligations of paragraphs (1), (2), and (4) of Section 206. These paragraphs require an adviser to disclose to clients any material facts concerning the adviser's conflicting interests. Disclosure required by Section 206(3) must be in writing. Disclosure need not be in writing under paragraphs (1), (2), and (4).

133/ See infra, Appendix B, text accompanying notes 52 to 61.

(2) Form ADV

The brochure rule 134/ requires investment advisers required to register under the Act to provide Part II of Form ADV, or a document containing, at a minimum, the information in Part II of Form ADV, to advisory clients upon initiation of an advisory relationship. The Form requires that advisers disclose conflicts of interest in two different ways: First, the Form poses a series of questions to which the adviser must respond by "checking a box"; second, the adviser must describe, in narrative form, the details underlying affirmative answers to the box-checking questions.

The key questions regarding conflicts of interest are as follows: 135/

- Does the adviser offer investment advisory services for commissions? (question 1C(5))
- Is the adviser actively engaged in a business other than giving investment advice? (question 7A)
- Does the adviser sell products or services other than investment advice to clients? (question 7B)
- Does the principal business of the adviser or its principal executive officers involve something other than providing investment advice? (question 7C)
- Is the adviser registered as (or has it applied to become) a securities broker-dealer (or commodities future professional)? (questions 8B and C)
- Does the adviser have arrangements that are material to its advisory business or its clients with a related person who is a broker-dealer, investment company, other investment adviser, financial planning firm, commodities professional, accounting firm, law firm, insurance company or agency, pension consultant, real estate broker or dealer, or an entity that creates or packages limited partnerships? (question 8C)

134/ See infra Appendix B.5.b.(4). This disclosure is required by Rule 204-3, 17 C.F.R. § 275.204-3.

135/ Most of the questions that follow are direct quotes from the Form. A few are paraphrases. Part II has other questions as well. The ones set forth here address conflicts of interest.

- Is the adviser or a related person a general partner in any partnership in which clients are solicited to invest? (question 8D)
- Does the adviser or a related person, as principal, buy securities for itself from or sell securities it owns to any client? (question 9A)
- Does the adviser or a related person as broker or agent effect securities transactions for compensation for any client? (question 9B)
- Does the adviser engage in agency cross transactions? (question 9C)
- Does the adviser recommend to clients that they buy or sell securities or investment products in which the adviser or a related person has some financial interest? (question 9D)
- Does the adviser buy or sell securities that it also recommends to clients? (question 9E)

Two other Form ADV questions require disclosure about conflicts: one asks whether the adviser has discretion regarding clients' securities trading, selection of brokers, or commissions paid to brokers (question 12); the other asks whether the adviser is compensated by third parties for giving advice to clients, or compensates third parties for client referrals (question 13).

b. Survey of disclosures on Form ADV

To assess disclosures actually made on Form ADV by financial planners who are registered advisers, a random sample of 98 Forms ADV were reviewed. These Forms ADV were drawn from a listing of all advisers registered with the SEC who had answered "yes" to the question on Part I of Form ADV asking whether the adviser provided financial planning services. 136/ Part II of the Forms ADV filed by the planners in the sample were reviewed to assess the disclosures made.

136/ The list was of the approximately 6000 advisers registered with the SEC on March 30, 1987 who had answered "yes" to the question whether they provided financial planning services.

(1) "Box checking"

One way to assess the disclosures advisers make concerning possible conflicts of interest is to examine for consistency their answers on the Form ADV to the questions regarding conflicts of interest. For example, as set forth above, there are a number of questions on the Form concerning:

* the adviser's affiliations or activities with broker-dealers (questions 8A, 8B, 8C(1), 9B),

* the adviser's sale of products to clients (questions 1C(5), 7B, 9A),

* the adviser's other businesses (question 7A, 7C), and

* the adviser's financial interest in the products it recommends to clients (8D, 9D).

To determine whether the advisers' disclosures had a reasonable degree of internal consistency, a number of cross tabulations were done of the questions with seeming common roots. For example, question 1C(5) asks whether the adviser offers investment advisory services for commissions; question 8C(1) asks whether the adviser has "material" arrangements with a broker-dealer. Most advisers answering "yes" to question 8C(1) might also be presumed to earn commissions, at least indirectly, from their advisory clients, and therefore need to respond affirmatively to question 1C(5). However, of the 52 advisers who answered "yes" to the broker-dealer "material arrangement" question, 28, or more than half (54%), answered "no" to the commission question.

Another set of questions that could indicate internal consistency of disclosures, is, again, the "commission" question (question 1C(5)) and the question whether the adviser sells products or services other than investment advice to clients (question 7B). Of the 59 advisers who affirmatively answered question 7B (disclosing that they did sell products or services other than investment advice to clients), 31, or 53%, responded negatively to the "commission" question.

Finally, concerning the "commission" question (question 1C(5)), one might expect some consistency between an affirmative response to that question and the question concerning whether the adviser or a "related person" as a broker or agent effects securities transactions for compensation for any client (question 9B). Of the 54 advisers who answered "yes" to the broker question, 30, or 55%, answered negatively to the "commission" question.

These answers suggest, but do not conclusively demonstrate, some inconsistency in the responses. An adviser with a broker-dealer affiliate could answer "no" to question 1C(5) and "yes" to questions 8C(1) and 9B, on the theory that its commission income was earned from performing the broker-dealer activities, not from rendering advice.

One pair of questions should have a very close correlation: question 8C(1) ("material" relationship with a broker-dealer) and question 9B (adviser or related person acts as a broker). Any adviser who answers "yes" to one should generally answer "yes" to the other, and any adviser who answers "no" to one should generally answer "no" to the other. Of the 98 advisers in the sample, 76, or 78%, did answer the pair of questions consistently; 22 did not. Of the 22, 10 said that they did have a "material" arrangement with a broker-dealer, but did not themselves or through a related person act as a broker-dealer. The other 12 answered in the reverse.

(2) Written disclosures

Part II of Form ADV requires a written explanation of questions answered in the affirmative. An evaluation of the quality of these written disclosures, both as to their inherent clarity, and in relation to the "boxes" checked, is necessarily a subjective one. Set forth below are a few examples of disclosures that seem reasonably clear as to the adviser's financial interest in products sold, and a few that do not. The advisers who made good narrative disclosure also generally checked the "correct" boxes.

"GOOD" DISCLOSURE

Adviser # 1: [Adviser] sells insurance products and receives commissions on those products.

[Adviser] is a registered representative with [Broker-dealer Firm], a registered Broker-dealer located at [address]. [Adviser] may also be an agent of [a mutual fund timing service]. As a result, if an advisory client implements recommendations made by [Adviser] by purchasing securities, there may be a conflict of interest since [Adviser] may receive commissions through [Broker-dealer Firm] his Broker-dealer.

Adviser # 2: I am a Registered Representative of [Broker-dealer Firm], a wholly owned subsidiary of [Firm]. . . . I may recommend products offered by [Broker-dealer Firm] or its affiliates. If my Client purchases these products through me, as a Registered

Representative of [Broker-dealer Firm], I will be compensated based on [Broker-dealer Firm's] normal commission schedule. Thus a conflict of interest exists. The client is under no obligation to purchase products I recommend, or to purchase such products through me or [Broker-dealer Firm].

Adviser #3: [Individual], an associated person with [Adviser], is a registered representative with [Broker-dealer Firm], a registered securities broker-dealer. As such he may receive commissions on certain investments clients may make. Persons associated with [Adviser] normally will suggest the use of the above broker to clients. The products offered through this arrangement will be the same as investments offered currently by other brokerage firms, and commissions will be those common in the industry. [Adviser] may at times sell securities to or buy securities from investment advisory clients or others as principal. [Adviser] may also recommend the purchase or sale of securities in which it or persons associated with [Adviser] may have a position.

While such relationships as those detailed above do present a conflict of interest because persons associated with [Adviser] will be receiving advisory fees while at the same time they may also be receiving commissions or other fees for the sale of securities, insurance or real estate, these facts are always disclosed to clients, the conflicts of interest are pointed out, and clients are free to seek execution of their orders and other transactions elsewhere.

"POOR" DISCLOSURE

Adviser #4: Insurance and investment products are sold on a commission basis only.

The marketing of insurance & investment products comprise most of the applicant's activities.

* * * *

As a registered representative with [Broker-dealer firm] investment transactions may take place. However, the client is free to choose any broker-dealer or insurance company for the implementation of his/her plan. Furthermore, the client is free

to select investment or insurance products other than those generically recommended.

[This adviser did not check "yes" to the commission income question.]

Adviser #5: During implementation I will take on the role of a registered representative with [Broker-dealer Firm] and will make sales of securities. This will occupy about 10% of my time.

[Broker-dealer Firm] is the broker-dealer through whom our investments would be made. It is a sister division of [Adviser's employer]. A representative of [Broker-dealer Firm] of which I am a registered representative, would actually make the securities sales to clients.

* * * *

After the planning is finished and implementation begins I will assume the role of a registered representative with [Broker-dealer Firm]. It will be made clear to the client that at the termination of the planning agreement I will be changing roles.

[This adviser did not check "yes" to the commission income question.]

Adviser #6: [Discussion of fee structure.] In addition I receive compensation from products sold through insurance companies and a broker dealer.

* * * *

[Adviser] also sells insurance and securities on a full time basis.

[Adviser] is registered with the [NASD] as a principal with [Broker-dealer Firm]. [Adviser] is also a general agent with [Life Insurance Firm].

[This adviser did not check "yes" to the commission income question.]

c. Broker-dealer disclosure

This report does not purport to provide a comprehensive review of a broker-dealer's obligations to disclose to clients

the "interest" the broker has in transactions effected for customers. The following is a brief summary of some of the key disclosure obligations.

Rule 10b-10 under the Exchange Act requires a broker-dealer executing a transaction with a customer to provide a written confirmation at or before completion of the transaction disclosing information concerning the transaction. 137/ The confirmation provides a customer with the terms of the trades executed by a broker-dealer. For trades in certain over-the-counter and exchange-listed securities, in which the broker-dealer acted as agent for the customer, the confirmation must disclose both the transaction price and the commission (or other remuneration). 138/ In trades in which the broker-dealer acted as a "risk" principal, 139/ the broker-dealer must disclose the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer in the transaction. Mark-ups would constitute the difference between the two prices. 140/ In riskless principal transactions, 141/ the

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137/ 17 C.F.R. § 240.10b-10 (1987). The confirmation rule applies to transactions in all securities except United States Savings Bonds and Municipal securities. Municipal Securities are governed by MSRB Rule G-15 which provides disclosure requirements similar to Exchange Act Rule 10b-10.

138/ 17 C.F.R. § 240.10b-10(a)(7)(ii) (1987).

139/ A broker-dealer acts as a risk principal in a "transaction in which a broker-dealer sells securities to a customer out of its bona fide inventory or takes a customer's securities into its bona fide inventory." See Securities Exchange Act Rel. No. 15251, at n.54 (Oct. 20, 1978) (available in 15 SEC Docket 1370, 1328 (1978)).

140/ 17 C.F.R. § 240.10b-10(a)(8)(i)(B).

141/ A riskless principal transaction is one in which a broker-dealer (other than a market maker) acting as principal for its own account, after receiving an order to buy or sell a security from a customer, purchases the security from another person to offset a contemporaneous sale to such customer or sells the security to another person to offset a contemporaneous purchase from such customer. See Securities Exchange Act Rel. No. 15220 (Oct. 6, 1978) (15 SEC Docket 1260, 61 (1978).

broker-dealer must disclose the amount of any mark-up, mark-down, or similar remuneration received by a broker-dealer. 142/

Rule 15c1-5, in essence, requires disclosure by broker-dealers of their relationship, if any, with the issuer of securities they sell to customers. The Rule defines as a "manipulative, deceptive, or other fraudulent device or contrivance," a broker-dealer's "induc[ing] the purchase or sale by such customer of" any security of an issuer with which the broker-dealer is under common control, unless the broker-dealer discloses the control relationship to the customer. 143/ Rule 15c1-6 requires similar disclosure of the broker-dealer's participation in the distribution of, or interest in, securities it sells or buys for customers. 144/

A broker-dealer is not required to send written confirmations for investments in money-market funds if the broker-dealer gives to the customer within five business days after the end of each monthly period a document disclosing, for example, each purchase or redemption. 145/

D. Registration

Under this heading, the Subcommittee asked the following questions:

> With what state or federal regulatory authorities or self-regulatory organizations are financial planners registered?
>
> Do the financial planners: file reports, submit to inspections or otherwise communicate with authorities or organizations?

142/ 17 C.F.R. § 240.10b-10(a)(8)(i)(A) (1987).

143/ 17 C.F.R. § 240.15c1-5 (1987). The Rule also requires such disclosure before the broker-dealer "effect[s] with or for the account of a customer any transaction in" such security.

144/ 17 C.F.R. § 240.15c1-6 (1987). The Rule also requires disclosure before the broker-dealer does any act "designed to effect with or for the account of such customer any transaction" in such security.

145/ 17 C.F.R. § 140.10b-10(c) (1987) requires this disclosure. Additional disclosure requirements are set forth in Rule 10b-10(c).

This section answers these questions; it is organized into subsections on registration by 1) the federal government, 2) state governments, 3) self-regulatory organizations, and 4) other organizations.

1. Federal registration

A financial planner is not required to register with any federal regulatory authority unless it meets the definition of an adviser under the Advisers Act or engages in activities, such as that of broker-dealer, that require registration under the Exchange Act. As noted earlier, the Advisers Act's definition of "adviser" includes "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . . . " 146/ Some commenters believe that "it is virtually impossible today for a financial planner not to provide advice about securities". 147/ If this were the case, most financial planners would be advisers required to register with the SEC. 148/ There is, as yet, insufficient data from which to verify this view.

As disclosed in Table 15, from October 1, 1980 to October 1, 1987, the number of investment advisers registered with the SEC increased from 4,580 to an estimated 12,700; a growth of 173%.

146/ Investment Advisers Act, § 202(a)(11).

147/ Note, Financial Planning: Is it Time for a Self-Regulatory Organization?, 53 Brooklyn L. Rev. 143, 166 (1987) [hereinafter Financial Planning Note].

148/ Unless, of course, they were associated with an already registered investment advisory firm, or with a bank. See infra Appendix B.2., "Exclusions from the Definition of Investment Adviser."

Table 15

INVESTMENT ADVISERS REGISTERED WITH THE SEC
AT THE BEGINNING (OCTOBER 1) OF THE FISCAL YEAR

Year	Number
1981	4,580
1982	5,100
1983	5,445
1984	7,043
1985	9,083
1986	11,100
1987	11,000
1988	12,700 est.

Source: ADV Database.

The SEC staff believes that financial planners account for most of the growth in new registrants, but cannot substantiate this belief because, until 1986, Form ADV did not require the registrant to disclose the registrant's financial planning activities. Of the 12,700 investment advisers registered with the SEC, slightly more than half -- 7,000 -- currently report that they do financial planning. 149/

There is a vast discrepancy between estimates of the number of financial planners (50,000 to 250,000) in the literature 150/ and the number (7,000) estimated to be registered with the SEC. This discrepancy is partly explained by three factors.

First, estimates in the literature are usually based on the number of individuals who hold themselves out as performing financial planning. The SEC's figures are based on the number of entities, not individuals, that register. An entity can be one individual or can include several thousand employees. There is at least one registered adviser who employs 5,000 individual planners. In addition, even if the SEC staff were to tally the number of individuals employed by each financial planner registrant, limitations on Form ADV would prevent an accurate count because Form ADV has only one reporting category for registrants with 10 or more employees -- "10 or above." The ADV Database is thus simply inadequate to identify the number of individual planners employed by all but the smallest firms.

Second, the term "financial planner" is a catch-all for many activities that do not require registration, either at the SEC or in most states. For example, accountants providing only tax advice can call themselves financial planners and, as long as they do not receive special compensation for financial planning and the planning is solely incidental to their accounting practice, they do not have to register with the SEC. The same is

149/ See Chapter IV.B. (describing the ADV Database). In a report by the NASD it is estimated that approximately 50% of registered advisers are NASD members or associated persons. Nat'l Ass'n of Sec. Dealers, NASD Investment Adviser Pilot Examination Program, Association's Examination Study Group Report 8 (1986) (quoting SEC) [hereinafter NASD Pilot Exam Report].

150/ CFA Report, supra note 16, at 7. See also Kapner, NASD Looking Toward Creation of SRO for Investment Advisers, Inv. Dealers Dig., Nov. 4, 1985, at 4; Kapner, Financial Planning Industry Moves to Regulate Itself, Inv. Dealers Dig., July 22, 1985, at 8.

true for attorneys, insurance agents, broker-dealers and banks. Therefore, many financial planners may not be required to register with the SEC as investment advisers.

Finally, there is a public relations value to the use of the term "financial planner". Given that there are no restrictions on the use of that term, it is not surprising that a wide discrepancy exists between the number of planners registered with the SEC and the number of individuals reported in the literature to be financial planners.

Persons required to register with the SEC as advisers must comply with the Act's reporting 151/ and record keeping provisions. Registrants are also required to follow specific custody requirements. The SEC periodically inspects registrants to determine their compliance with the Act. 152/

As noted earlier, if, in addition to investment advice, the financial planner provides other services, it may have to register those other activities as well. For example, if an adviser acts as a broker-dealer, it will have to register with the SEC and relevant self-regulatory organizations pursuant to the provisions of the Exchange Act. 153/ If the planner sells insurance or real estate, it will have to be licensed to sell those products by the appropriate state or states.

2. State registration

An increasing number of states regulate financial planners or advisers or both. The majority of states (40) regulate advisers under their securities laws. 154/ Most jurisdictions

151/ Advisers register on Form ADV and file annual reports on Form ADV-S. They must amend Form ADV to disclose material changes. Additionally, they must furnish an informational brochure to clients, either by using Part II of the Form ADV or material containing all of the information in Part II. These requirements are discussed more fully infra, Appendix B.

152/ The SEC's inspection program is discussed infra Chapter V.E.

153/ A large number of financial planners are so registered.

154/ II Inv. Co. Inst., Investment Advisers Guide (State) 8-1 (1987) [hereinafter Investment Advisers Guide]. States that do not have requirements for adviser registration are: Alabama, Arizona, Colorado, Georgia, Iowa, Massachusetts, North Carolina, Ohio, Vermont, Wyoming, and Washington, D.C. (continued...)

that require registration of advisers and many that otherwise regulate advisers have adopted the Uniform Securities Act ("Uniform Act"). 155/ The Uniform Act, among other provisions, provides for the registration and regulation of advisers. The Uniform Act requires advisers to file annual financial reports and correcting amendments as needed and prohibits fraudulent activities. The Uniform Act also provides for periodic inspection of all records maintained by advisers. Dishonest or unethical practices in the securities business are considered grounds for revocation or suspension of registration in most states. 156/ Uniform Form ADV, the same as the SEC's Form ADV, is used for adviser registration in most States.

In the Uniform Act, the term "investment adviser" is defined to exclude banks, attorneys, accountants, teachers, engineers, broker-dealers, publishers, government securities advisers, and persons who have no place of business in the particular state. Generally, an adviser's compliance with the record keeping requirements of the Advisers Act will satisfy the states' record keeping requirements. 157/ Finally, the Uniform Act restricts the use of performance fees. 158/

Some states have only adopted parts of the Uniform Act. For example, eight jurisdictions that have adopted most of the Act do not require advisers to register. 159/ But most states that have adopted the Uniform Act have gone beyond its provisions. For example, although neither the Uniform Act nor the Advisers Act requires the registration of adviser representatives, twelve States have added that specific provision. 160/ A few States that have not adopted the Uniform Act nonetheless require the registration of representatives or agents of advisers. 161/

154/(...continued)
See the State-By-State summary.

155/ Id. at 8-1.

156/ Id. at 8-4.

157/ Id. at 8-2, 8-3. States may differ in the number of years records are required to be maintained.

158/ Id. at 8-37.

159/ Id. at 8-6.

160/ Id.

161/ Id.

States that have not adopted the Uniform Act but which nevertheless require registration of advisers have some laws and regulations similar to those in the "uniform" states. However, in many cases, the provisions of the individual non-uniform state acts vary considerably from those of the Uniform Act. In some instances the non-uniform acts are stricter. For example, seven of the non-uniform states require an applicant to pass a qualifying examination to become licensed as an adviser or to become qualified as an adviser representative. Only 19 of the 31 states that have passed the Uniform Act also have an examination requirement. 162/

Several states also have provisions detailing the manner in which customer accounts are to be segregated if the adviser retains custody of client funds or securities. Several state laws also contain some regulation of advertising. 163/

Some states also prohibit licensed advisers from representing themselves as financial planners when the representation does not accurately describe the nature of the services offered, the qualifications of those offering the services, or the method of compensation for the services. 164/

A number of states prohibit an individual from acting as both a broker-dealer and an adviser unless the brokerage and advisory firms are under common control, or unless the broker-dealer acknowledges in writing that it is aware that the employee is also active as an investment adviser. States concerned with the dual registration of brokers and advisers frequently require advisory contracts to contain specific disclosures or otherwise require the adviser to obtain specific acknowledgements from the client that separate fees may be charged for both the advisory and brokerage activities.

162/ Id. at 8-7, 8-8. The Uniform Act does not require advisers to pass qualifying examination.

163/ Id. at 8-7.

164/ Address by Conrad G. Goodkind, Investment Company Institute Conference on Investment Adviser Operations and Regulation (June 20-21, 1984) (discussing special state registration considerations).

3. Self-regulatory organizations

There are, at present, no federally recognized investment adviser self-regulatory organizations ("SROs"). But, as discussed below, data from the ADV Database, the literature, and the SEC Special Planner Inspections all reveal a large number of dually registered advisers/broker-dealers. Since broker-dealers and their registered representatives must, by law, be members of a self-regulatory organization, 165/ many financial planners belong to a self-regulatory organization -- usually the NASD -- but do not belong to an SRO that regulates advisory activities.

The ADV Database shows that almost half of the registered advisers are either registered securities broker-dealers (10%); or have arrangements material to an advisory business or clients with related persons who are broker-dealers (35%). The percentage of financial planners who are also registered representatives and registered with the NASD is consistently high among the various financial planning surveys: 83% of the ChFC members, 166/ 73% of the NALU members who do financial planning, 167/ 70% of the IAFP members, 168/ 63% of the CLU members, 169/ and 24% of the FAF members 170/ report that they are registered with the NASD. A survey of financial planners listed in the California Yellow Pages found that more respondents were members of the NASD

165/ Securities Exchange Act of 1934, § 15(b)(8), 15 U.S.C. § 78o(b)(8).

166/ Selective summary of 1985 ASCLU membership survey (attached to letter from Burke A. Christensen, ASCLU Vice President & General Counsel, to Div. of Inv. Management, SEC (Aug. 20, 1986)) [hereinafter 1985 ASCLU Selective Summary].

167/ 1984 NALU-LIMRA Survey, supra note 43, at 3.

168/ 1986 IAFP Membership Survey, supra note 60, at 2.

169/ 1985 ASCLU Selective Summary, supra note 166.

170/ FAF Membership Survey, supra note 99, at I-19. In addition, 14% of the members of the AICPA Personal Financial Planning Division hold insurance broker or agent licenses, 11% are licensed broker-dealers, and 11% are real estate brokers. AICPA PFP Questionnaire, supra note 72.

(49%) than of any other organization, financial planning or otherwise. 171/

The SEC Special Planner Inspections found that of the 69 active product sales organizations affiliated with the 81 active inspected financial planners, 23 were registered as broker-dealers. All 23 broker-dealers were registered with at least the NASD. The remaining 46 entities were associated persons of broker-dealers. The sales activities of these associated persons are subject to the supervision of the registered broker-dealer.

4. Other organizations

The number of professional associations to which financial planners may belong is growing rapidly, each promoting its own definition of financial planning and its own ethical guidelines. 172/ Since membership in these organizations is voluntary, the organization's control over members is limited; when it brings an expulsion proceeding against a planner, the planner simply quits the organization. Nevertheless, the codes of conduct of these organizations have some effect on members, and loss of membership in some organizations can serve as a limited deterrent to improper conduct.

In addition to joining voluntary membership associations, many financial planners are members of a recognized profession -- attorney, accountant -- or have passed a qualifying examination. For example, to become a Certified Financial Planner (CFP), a candidate must meet certain education, examination, and experience requirements. 173/

A certifying board, the IBCFP, now grants and revokes the CFP designation. A survey of IBCFP members presents the multifaceted professional profile typical of planners: 36% of IBCFP's members are also CPAs, 34% are also CLUs, 20% are also

171/ Cal. Dep't of Corp. Survey, supra note 92, at 5; 48% belonged to the IAFP.

172/ Heffernan, Association Overload, Financial Planning, October 1986, at 100. A glossary of terms, including professional and trade associations, is provided in Appendix D.

173/ ICFP, a voluntary membership organization for financial planners with the CFP designation (or who are candidates for the CFP), has approximately 16,000 members. Investment Adviser, Financial Planner Subcomm. Hearings, supra note 2, at 183 (testimony of Charles E. Hughes, Jr., ICFP).

ChFCs and 10% are also JDs. 174/ Similarly, 36% of the ChFC members and 21% of the CLUs have additional professional affiliations (excluding registered representative and registered adviser). 175/ Of the respondents to a survey of financial planner/NALU members, 10% were CLU certified, 14% were ChFCs and 16% were enrolled in ChFC courses. 176/

The Chartered Financial Analyst ("CFA") designation is awarded by the Institute Of Chartered Financial Analysts, which administers the three examinations for the designation. In addition to the requirement to pass all three tests, candidates must have had three years of experience, and comply with a code of ethics and standards of professional conduct. The affiliated Financial Analysts Federation ("FAF") is a membership organization composed of investment managers and securities analysts who have passed the first CFA examination and are members of one of the 57 affiliated chapters and societies. The Code of Ethics and Standards of Professional Conduct are identical to those that of the Institute and both bodies have disciplinary programs that cooperate for joint members. The Institute has chartered 10,000 individuals as CFAs, and the Financial Analysts Federation lists 16,000 members. 177/

The Registry of Financial Planning Practitioners is administered by the International Association for Financial Planning.

174/ 1987 IBCFP Survey Results, supra note 71.

175/ ASCLU & ChFC 1985 Survey, supra note 61, at 30.

176/ 1984 NALU-LIMRA Survey, supra note 43, at 4. Other indications of the multiple memberships of planners may be found in the literature. Responses to an FAF survey disclose that 48% of the respondents are CFAs, 6% are certified investment counselors and CPAs, financial planners and attorneys are each 2%. FAF Membership Survey, supra note 98, at I-19. The IAFP claims to have more than 23,000 active members. CFA Report, supra note 16, at 19. The 1986 IAFP membership survey shows that 31% of those responding are CFPs, 20% are CLUs, 17% are ChFCs, 13% are CPAs (the fastest growing category) and 5% are lawyers. In addition, 70% hold life insurance licenses, 60% have health insurance licenses and 19% are licensed real estate agents. 1986 IAFP Membership Survey, supra note 60, at 2. This group ranked their primary affiliations as: IAFP- 50%, ICFP-17%, NALU- 13%, CLU- 11%, AICPA- 9%. Id. at 2.

177/ Morley, What's So Special About a CFA?, Pension World, Sept. 1985.

The Registry requires that candidates be in financial planning practice for three years, possess a CFP, ChFC, CPA, JD, LLM or a bachelors degree in business, pass a practice knowledge examination, provide references from five clients that have used the planner for two years and had a plan prepared, and submit a sample plan prepared for a client for review.

Registered advisers involved in financial planning and surveyed for the SEC Special Planner Inspections reported the following qualifications and memberships among non-clerical employees: 26% CFPs, 19% CLUs, 15% ChFCs, 14% listed in the Registry of Financial Planning Practitioner, 178/ 11% attorneys, and 10% CPAs. Advisers engaged in product sales generally fall into the same categories: 30% are CFPs, 21% are CLUs, 14% belong to the IAFP Registry, 12% are ChFCs, and 11% are attorneys. CFAs account for less than 3% of the registrants.

5. Summary

Financial planners, if they are advisers, register with the SEC and the securities regulators of most states. The SEC registered planners file annual reports and are subject to periodic inspections. The requirements of the states vary. Those registered advisers who also sell securities, and so are either broker-dealers or associated with broker-dealers, register with the SEC, the states, and self-regulatory organizations in their sales capacity, file annual reports, and submit to inspections. Many of the planners -- the proportion varies from source to source -- also sell insurance and so are regulated in that capacity by state insurance commissions.

E. Examinations/Inspections

Under this heading, the Subcommittee posed the following questions:

> What level of examinations are financial planners/advisers subjected to?
>
> What is the: amount of time before the first inspections and between subsequent inspections, number of existing uninspected planners/advisers, result of inspections, number and kind of violations, number and outcome of cases brought, and method of detecting violations (i.e., is detection the

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178/ The IAFP Registry is discussed in the previous paragraph.

result of a scheduled inspection or a customer complaint)?

Although the Subcommittee asked the SEC generally to examine "the degree of abuse" in the industry, only the Subcommittee's requests relating to the inspection of advisers specifically requested data on law violations. Because of the importance of a discussion of law violations to full analysis of the advisory industry, the Subcommittee's last two questions above -- which deal with the cases brought and the detection of violations -- are covered in a separate subsection on enforcement.

The SEC's regional offices maintain the dates of adviser inspections on card files as part of their inspection targeting program. 179/ These data are not included in the SEC's central database and, therefore, exact numbers of first inspections, subsequent inspections, and existing uninspected advisers were not available. Other data were used to describe the frequency and scope of inspections.

1. Frequency and scope of inspections 180/

An important means by which the SEC oversees the regulation of advisers is the investment adviser inspection program. 181/ Each regional office is responsible for conducting a predetermined number of investment adviser inspections each year. The primary purposes of adviser inspections are: (1) to ascertain whether the adviser is in compliance with the Advisers Act and the rules and regulations thereunder; and (2) to ensure that the adviser's activities and services are consistent with the information disclosed to clients in the adviser's Form ADV 182/ and other documents furnished to clients. The inspections focus

179/ The files are now in the process of being computerized.

180/ For the sake of clarity, the activity of visiting, examining and reviewing an adviser's place of business will be referred to as an "inspection" rather than an "examination."

181/ Financial planners that are exempt from the Advisers Act because they are broker-dealers are subject to extensive SEC and self-regulatory organization inspection programs. See Securities Exchange Act § 17, 15 U.S.C. § 78q.

182/ Part II of Form ADV can be and often is delivered to clients to satisfy the brochure rule. Form ADV is discussed more fully infra Appendix B, text accompanying notes 30 to 37 and the brochure rule is discussed more fully infra Appendix B, text accompanying notes 62 to 63.

on the adviser's books and records, sales materials, investment activities, and the adviser's relationships and agreements with clients and affiliates.

Inspections are generally conducted on a surprise basis. Regional office examination staff choose which advisers to inspect since they are in closest touch with the advisers in their geographical area, and thus best able to keep track of possible problems.

Table 16 shows the number of advisers at the beginning of each year, the number of inspections performed each year, the percentage of the adviser population inspected each year, and the number of adviser inspections per staff year 183/ from 1980 to 1987.

Table 16

INVESTMENT ADVISER INSPECTIONS
1980 - 1987

	1980	1981	1982	1983	1984
Advisers	4,580	4,580	5,100	5,445	7,043
Inspections	529	512	710	737	837
% Inspected	11.6%	11.2%	13.9%	13.5%	11.9%
Inspections/ staff year	10.5	10.4	18.6	18.7	24.3

	1985	1986	1987
Advisers	9,083	11,100	11,000
Inspections	1,039	1,337	1,294
% Inspected	11.4%	12.0%	11.8%
Inspections/ staff year	23.6	25.3	27.1

Source: Compilation of SEC In-House Data

183/ A staff year is the equivalent of one person working an entire year -- 2080 hours (52.2 weeks @ 40 hours/week).

The table shows that the percentage of the adviser population inspected each year has varied from a low of 11.2% in 1981 to a high of 13.9% in 1982 when a major change in the way inspections were conducted was implemented. The decline in the percentage of advisers inspected annually between 1982 and 1987 is the result of the rapid growth in the adviser population rather than a decrease in the productivity of the inspection staff. Actually, the productivity of the inspection staff increased by over 156% in seven years, from 10.6 inspections per staff year in 1980 to 27.1 in 1987.

In addition to increasing productivity, the SEC's inspections program has also sought to improve the use of inspection time.

First, the SEC has increasingly tailored the scope and focus of adviser inspections to mirror the perceived risk in a particular adviser's operations. Second, the SEC has better coordinated inspections with state-conducted inspections. 184/ Finally, the SEC has made more effective use of inspection time by targeting for inspection those advisers who pose a risk to client assets either because of the nature of the adviser's business, or because of information in the SEC's possession pointing toward possible problems in the adviser's business. New advisers are also targeted for inspection, since an early review of their operations helps to acquaint them with their regulatory obligations and builds a foundation for later compliance. However, the SEC cannot inspect all new advisers during their first year of operation, because in most recent years the increase in new advisers per year has been larger than the number of inspections conducted per year.

The level of deterrence achieved from the inspection program is at least partly a function of each adviser's perception of the

184/ This coordination has taken a number of forms. For example, the SEC together with NASAA has developed a Form ADV that is uniform for the federal government and most of the states. This uniformity has eliminated gaps between the information required for federal and state regulation, and has increased the efficiency of adviser examinations. The SEC has also implemented a joint inspection and training program with the states. Under this program, the SEC staff has trained examiners in 20 states. Additionally, the SEC exchanges inspection schedules and findings with state examiners to increase inspection coverage and minimize duplication. For a discussion of the role of the states in the regulation of investment advisers see supra text accompanying notes 154 to 165.

probability of being inspected: the higher the percentage of the adviser population inspected, the greater the deterrent effect. The examination picture is complicated, however, because advisers whose activities pose a higher risk to client assets are inspected more frequently than those who do not.

2. Inspection results

Table 17 discloses the cumulative results of the SEC's inspection program over the last seven years (1980-1987). Table 17 shows: the number of inspections completed, the number of deficiency letters sent, the percentage of inspections that resulted in a deficiency letter, the number of inspections referred for possible enforcement action, and the percentage of total inspections referred for possible enforcement action.

Table 17

INVESTMENT ADVISER INSPECTION RESULTS
1980 - 1987

	1980	1981	1982	1983	1984
Inspections	529	512	710	737	837
Deficiency letters	310	235	522	471	446
% Letters/inspected	59%	46%	74%	64%	53%
Enforcement referrals	26	33	45	35	56
% Referrals/inspected	4.9%	6.4%	6.3%	4.7%	6.6%

	1985	1986	1987	8 Years average
Inspections	1,039	1,337	1,294	848
Deficiency letters	538	820	597	467
% Letters/inspected	52%	61%	54%	55%
Enforcement referrals	65	75	70	50.6
% Referrals/inspected	6.5%	6.5%	6.3%	6.0%

Source: Compilation of SEC In-House Data

Deficiency letters are sent to advisers when violations are discovered during inspections. Thus, the percentage of inspections that result in deficiency letters is an indication of the extent of violations among registered advisers. 185/

Inspectors refer most advisers with serious inspection deficiencies to the enforcement staff in the regional office. From 1980 to 1987 the percentage of inspections that resulted in enforcement referrals was in the 6% range. As with the deficiency letters, enforcement referral percentages have stayed relatively constant despite the increased productivity of the examiners.

These results from the overall program of investment adviser inspections fail to show, however, the kinds of deficiencies frequently found in inspections of planner/advisers. To provide this information, the SEC 1986 Inspection Report Review was conducted. 186/

The review was of the 1,337 inspection reports completed for calendar year 1986, out of which 294 were identified as reports of inspections of financial planners. The deficiencies found by inspectors were categorized to match the twelve standard focus areas normally used by the SEC inspectors in inspecting advisers. 187/

a. Deficiencies

Table 18 presents in statistical format the results of the SEC 1986 Inspection Report Review. The first line lists the "inspection category" of the deficiencies. The numbers, 1 through 12, correspond to the following deficiency categories:

1. Books and records
2. Financial matters
3. Registration
4. Custody arrangements

185/ See infra Chapter V.E.2.b. ("Resolution of deficiencies") for a discussion of deficiency letters.

186/ For a description of the SEC 1986 Inspection Report Review, see supra Chapter IV.D.

187/ These focus areas are described more fully infra.

5. Investment activities
6. Securities transactions
7. Advisory services
8. Contracts
9. Fees
10. Conflicts of interest
11. Advertising
12. Correspondence

Table 18

DEFICIENCY AREAS BY INSPECTION CATEGORY
FOR 1986 INSPECTIONS 188/

	No. of Exams	Categories of Deficiencies 1	2	3	4	5	6	7	8	9	10	11	12
All insp.	1,337	668	124	588	105	24	58	33	273	70	80	285	10
Deficiencies as % of inspections completed		50%	9%	44%	8%	2%	4%	2%	20%	5%	6%	21%	1%
Non-planner inspections	1,043	523	110	447	93	21	55	26	198	57	57	217	9
Deficiencies as a % of non-planner inspections		50%	11%	43%	9%	2%	5%	2%	19%	5%	5%	21%	1%
Financial planner (FP) inspections	294	145	14	141	12	3	3	7	75	13	23	68	1
Deficiencies as % of FP inspections completed		49%	5%	48%	4%	1%	1%	2%	26%	4%	8%	23%	

Source: Compilation of SEC 1986 Inspection Report Review Data

188/ The number of deficiencies reported actually somewhat understates the number of deficiencies found. For example, if an adviser was found not to have maintained three required records, it would in fact have three deficiencies. However, the SEC has not in the past quantified deficiencies that way, so the adviser is reported to have one books and records deficiency. Starting in fiscal year 1988 each deficiency will be counted as one deficiency.

As shown by Table 18, the deficiencies reported for financial planners are roughly similar in proportion to those for all advisers, and for non-planner advisers. To provide more background on the type of deficiencies associated with financial planners, the following discussion summarizes the principal deficiencies reported for each category as well as the problems these deficiencies represent.

(1) Books and records

Advisers are required to maintain accounting records typical of any ongoing business (e.g., general and auxiliary ledgers, journals, and source documents including check books, bills or statements of account) in addition to some records kept specifically for the purposes of complying with the Act. The number of record-keeping violations by financial planners is roughly correlated to two factors: (1) the number of clients the financial planner has and (2) whether the financial planner is associated with or registered as a broker-dealer.

The less active a financial planner is, the smaller will be the business need to maintain and preserve all of the formal records required by the Act, and the less likely it will be to comply with books and records requirements. For an inactive planner, a personal checkbook may be the simplest means for keeping track of revenues and disbursements. Thus, the inactive financial planner is often in technical violation of most of the Act's record keeping provisions and such deficiencies are reported. However, such financial planners obviously pose little risk to clients so long as they remain inactive.

Advisers offering financial planning services who are also registered as or associated with a broker-dealer normally maintain books and records sufficient for many of the record-keeping requirements under the Act. Because these advisers are dually registered, their records are subject to additional review by other organizations including the NASD, the broker-dealer's internal compliance unit, and external auditors. The SEC staff has found that these other reviews effectively reduce the number of technical books and records violations under the Act.

(2) Financial matters

Advisers are not subject to stringent and complex statutory financial responsibility requirements as are broker-dealers, unless, of course, the adviser is also a broker-dealer. Solvency of the financial planner is nonetheless of concern to the SEC because, if a financial planner that collects fees in advance is insolvent, it may not be able to fulfill obligations to clients. During calendar year 1986, examiners reported that 14, or almost 5%, of the 294 financial planners inspected were technically

insolvent. The SEC attempts to resolve these situations by requesting that the financial planner show that the planner's financial condition will not prevent it from fulfilling obligations to clients. 189/

(3) Registration

Of the 294 planners examined in 1986, 141, or 48%, had registration deficiencies. Deficiencies arise when a planner does not meet the registration reporting requirements or does not comply with the brochure rule. 190/

Examiners found that many financial planners were misinformed about the requirement to keep their registration forms current. They were also generally unaware of the requirement to file with the SEC the annual reporting form for advisers. The brochure rule problem was most often a failure annually to "offer to deliver" the written disclosure statement to clients and to maintain a record showing when the statement was provided. 191/

(4) Custody arrangements

In 12, or 4%, of the 294 financial planner inspections, deficiencies were found involving the custody rules. A planner with access to or physical possession of client funds and securities has "custody." Custody requirements include annual verification of the amount of client funds and securities held by the planner, and a surprise audit by an independent public accountant. 192/ A financial planner with custody of client funds and/or securities presents a risk to clients that the funds and/or securities may be lost if the planner becomes insolvent.

In the 12 situations cited, the financial planners were found to have had custody of their clients' funds

189/ The SEC recently adopted Rule 206(4)-4, 17 C.F.R. § 275.206(4)-4 (1987) to require advisers with custody or discretionary authority to disclose to clients the adviser's financial condition if that condition is reasonably likely to impair the adviser's ability to meet contractual commitments to the client.

190/ For a discussion of the brochure rule, see infra Appendix B.5.b(4).

191/ See Rule 206(4)-3, 17 C.F.R. § 275.206(4)-3 (1987).

192/ Rule 206(4)-2, 17 C.F.R. § 275.206(4)-2 (1987).

unknowingly. 193/ To resolve these situations, the examiners required the financial planners to choose between altering their arrangements so as not to have custody, or complying with the custody rules. None of these situations involved the loss of client funds.

(5) Investment activities

Deficiencies reported under this category involved the failure of financial planners to disclose fully that their investment recommendations were limited to the investment products offered through an affiliated broker-dealer. 194/

(6) Securities transactions

Deficiencies reported under this category involved the planner's failure to report and maintain a record of the personal securities transactions of all advisory representatives. Three of the 294 financial planner inspection reports cited this deficiency. In each situation, the financial planner failed to have a formal procedure for reporting and maintaining a record of these transactions. In each case the identification of these deficiencies resulted in the financial planner adopting procedures to report personal securities transactions.

(7) Review of advisory services

This category refers to deficiencies found in the allocation of client transactions and turnover of client assets under management. Few (seven in 1986) deficiencies were reported in this category. In all cases the financial planner was registered or associated with a broker-dealer and failed adequately to disclose brokerage allocation practices to clients.

193/ The most common cause of unintended custody is an overbroad power of attorney given by the client to the adviser. Other causes include, an adviser's taking temporary possession of client securities to deliver them to a broker-dealer, and an adviser's acting as a trustee to a trust established by a client.

194/ This disclosure is required under the general antifraud provisions of Section 206 of the Investment Advisers Act [15 U.S.C. § 80b-6]. In addition, item 8 of Form ADV requires advisers to disclose and describe other financial industry activities or affiliations.

(8) Contracts

Deficiencies relating to client contracts were found in 26% of the financial planners inspected (75 out of 294) in 1986, a somewhat higher percentage than the 20% average for all advisory inspections. Planners were deficient in three basic areas relating to contracts: "non-assignment" clauses, 195/ "hedge" clauses 196/ and non-disclosure of client refund policies. All of these deficiencies are common in the investment advisory industry and are not unique to planners.

(9) Fees

Thirteen of the 294 planners inspected (4%) had deficiencies associated with fee arrangements. There were three types of deficiencies reported in this category -- all concerning failures to disclose. Financial planners failed to disclose that: (1) the fee arrangement was subject to negotiation, (2) partial or full refunds were available to clients, and (3) their fees were substantially in excess of those of others providing the same service. 197/

(10) Conflicts of interest

In 23, or 8%, of the financial planner inspections, examiners found conflicts of interest problems. Special inducements or compensation received by the financial planner from third parties requi[illegible] full disclosure to the client. 198/

As discussed earlier, financial planners whose compensation depends on commissions from sales of products they recommend present continuing conflict of interest problems. These compensation arrangements are of special concern in inspecting financial planners: they require examiners to focus on the total

195/ A "non-assignment" clause must be included in each contract, stating that no assignment of the contract will be made without client consent.

196/ A "hedge" clause in a contract is language that may mislead investors into thinking that they have waived rights they would otherwise have under law.

197/ These disclosures are required by the general antifraud provisions of Section 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1987).

198/ These arrangements are required to be disclosed under Rule 206(4)-3, 17 C.F.R. § 275.206(4)-3 (1987).

relationship of the financial planner to clients -- not just the traditional investment adviser relationship.

(11) Advertising

Examiners found that 68 of the 294 financial planners inspected had deficiencies involving advertising. The most frequent advertising problem noted with financial planners was their use of the term "Registered Investment Adviser" or initials "RIA." in promotional materials. 199/ The use of the term "Registered Investment Adviser", or the initials "RIA," suggests that the person so designated has a level of professional competence, education, or other special training not justified by that designation. Another problem found by examiners was the use of testimonials, which are forbidden by SEC rule. 200/ One problem fairly common to other advisers, but not to financial planners, is the use in publications and advertising of performance statistics. Most planners do not provide portfolio management services, so they have no performance results to present.

(12) Correspondence

Examiners' review of correspondence includes a review of client complaints, internal memoranda and other correspondence relating to the financial planner's business. One purpose of this review is to determine whether the planner is involved in undisclosed material litigation which might have an impact on the planner's advisory business. In the inspections conducted in 1986, one planner was found deficient for having failed to disclose such litigation.

b. Resolution of deficiencies

There are two procedures other than referring the matter for enforcement action used to resolve deficiencies and violations discovered in inspections. As noted earlier in this subchapter, the principal procedure is to send a deficiency letter to the

199/ Section 208(a) of the Advisers Act, 15 U.S.C. § 80b-8(a), prohibits a registered investment adviser from implying or representing that his registration with the SEC indicates an approval or recommendation by the United States Government. Section 208(b) of the Act, 15 U.S.C. § 80b-8(b), states that Section 208(a) shall not be interpreted to prohibit a person from stating that he is registered if he is registered and if the effect of the registration is not misrepresented.

200/ Rule 206(4)-1(a)(1), 17 C.F.R. § 275.206(4)-1(a)(1) (1987).

adviser. The letter details the violations found in the inspection and requests that remedial action be taken. The second method is to inform the investment adviser of the deficiencies found during the on-site visit and allow the adviser to take corrective action.

Of the 294 financial planner inspections conducted in 1986, inspectors did not report any deficiencies in 81, or 28%, of the inspections. For the remaining 213 inspections (72%), deficiency letters were issued in 195 (66% of all exams) inspections while 18 (6%) were resolved on-site. These results vary somewhat from those reported for the resolution of deficiencies among all adviser inspections as reported in Table 19. They show that a higher percentage of planners were deficient in some respects (72%) than were non-planner advisers (49%).

Table 19

RESOLUTION OF DEFICIENCIES REPORTED IN INVESTMENT ADVISER AND FINANCIAL PLANNER INSPECTIONS DURING CALENDAR 1986*

	Number of Exams Deficiencies Reported	Number of Exams Deficiency Resolved on Site	Number of Exams Deficiency Letter Sent
All exams (1337)	724 (54%)	63 (5%)	661 (49%)
Non-planner exams (1043)	523 (49%)	45 (4%)	466 (45%)
Financial planner exams (294)	201 (72%)	18 (6%)	195 (66%)

*Excludes enforcement referrals.

Source: Compilation of SEC 1986 Inspection Report Review Data

c. Summary

The regional offices conducted regular inspections of 294 financial planners in calendar 1986. These inspections represented 22% of all adviser inspections conducted by the SEC. Financial planners had a higher rate of deficiencies when compared to all investment advisers. The top four categories of deficiencies included: (1) books and records, (2) registration and reporting requirements, including the brochure rule, (3) contractual problems, and (4) advertising. Deficiencies from record keeping and registration, including the brochure requirements accounted for more than 50% of the deficiencies reported for financial planners.

Inspectors cited deficiencies in 72% of the financial planner inspections conducted during 1986. In most (92%) of these situations, deficiencies were addressed through a deficiency letter sent to the registrant. Deficiencies found in 18 examinations were resolved on-site by the examiner.

F. Enforcement

This subchapter addresses the Subcommittee's questions regarding law violations in the financial planner industry, and the SEC's program to deal with these violations. The SEC's enforcement program is limited necessarily to violations of law that fall within the SEC's jurisdiction. Information about violative conduct of the larger universe of financial planners is found in the literature. 201/ In addition, in compiling data about, or reporting its enforcement activities regarding, investment advisers, the SEC does not differentiate between advisers who are financial planners and those who are not. Consequently, the discussion and data that follow concern cases brought against investment advisers generally, not just cases brought against financial planners. The discussion and data do

201/ See, e.g., CFA Report, supra note 16; Bamford and Flanagan, Watch Your Assets, Forbes, Oct. 8, 1984, at 21-39; Miller, Financial Adviser's Tumble Brings Charges of Fraud and Huge Losses, Wall St. J., Mar. 27, 1986 (Sect. 2); Downscale Planning, Fin. Planning, Feb. 1987; Auerbach, Financial Planners?, Sylvia Porter's Personal Finance, December, 1984 at 26; Rose, Incentives vs. Clients: Which Ones Most Concern Financial Planners?, Wall St. J., Nov. 24, 1986; Quinn, Sponsors Are Sweetening the Pie for People Who Sell Mutual Funds, Wash. Post, Aug. 17, 1987 (Business); Buy, Hold, or Sell this Broker, Barrons, Aug. 24, 1987 (commenting on the "inherent conflict of interest" of commission dependent advisers).

not include cases brought against broker-dealers who were not also registered (or required to be registered) as investment advisers.

1. Method of detecting violations

Information about potential violations comes to the SEC in a number of ways, including from: public complaints, informants, the securities industry, state and local agencies, and the SEC's routine inspections of advisers. Cause inspections are conducted when the SEC learns of a problem warranting on-site examination of an adviser. 202/

2. Customer complaints

Table 20 shows the number of complaints about investment advisers received by the SEC for the years 1981 - 1986. The number is most likely somewhat understated because the SEC records complaints against advisers who are also broker-dealers as broker-dealer, not adviser, complaints. 203/

Table 20

TOTAL COMPLAINTS AND COMPLAINTS AGAINST INVESTMENT ADVISERS
1981 - 1986

	1981	1982	1983	1984	1985	1986
Total	16,148	11,832	18,534	21,673	22,261	24,960
Invest. adv.	184	179	284	332	484	471
% of Total	1.14%	1.51%	1.53%	1.53%	2.17%	1.89%

Source:

The table shows that the number of complaints against advisers has grown in recent years, both absolutely and in proportion to other complaints. The number is still a small percentage of overall complaints.

The SEC reviews complaints to determine what action is warranted. The complaint may prompt a cause inspection of the adviser or may trigger an enforcement action.

202/ The SEC's inspection program is described supra Chapter V.F.

203/ A review of 100 broker-dealer complaints suggested that approximately 6% involved financial advisers or some

3. Enforcement cases

The SEC's formal process for enforcing compliance with the federal securities laws begins with the opening of an investigation. 204/ The investigation will either end without formal action or will result in civil or administrative proceedings or criminal references. 205/ The sanctions imposed on advisers who are found to have violated the law range from censure, to suspension or bar, to court-ordered injunction, to (in rare cases) fines and imprisonment.

To analyze the cases brought by the SEC against investment advisers (some, but certainly not all, of which may be financial planners), releases in the SEC Docket from January 1983 to July 1987 were reviewed to cull out the injunctive actions, administrative proceedings, and criminal references concerning investment advisers. In addition, the SEC's Case Automated Tracking System was used to determine the origin of the cases, and to provide other information about the cases not provided in the Docket.

As noted earlier, cases investigated and charged by the SEC come from a variety of sources. The sources of enforcement activities are set forth below in Table 21.

204/ Investigations may be formal or informal. Formal investigations are ones in which the SEC has issued a formal order of investigation, authorizing the staff to subpoena books, records, and testimony.

205/ Injunctive actions against advisers are brought under Section 209 of the Advisers Act, 15 U.S.C. § 80b-9; in addition to seeking an injunction, the SEC can also request appointment of a receiver, the freezing of assets, or other equitable relief as may be appropriate. Administrative proceedings against advisers are brought under Section 203 of the Advisers Act, 15 U.S.C. § 80b-3. In these proceedings, the SEC may determine to revoke or suspend the registration of an adviser, to limit the adviser's activities, or to censure the adviser. Possible criminal cases that the staff believes are egregious are referred to the Department of Justice for prosecution.

Table 21

ORIGIN OF SEC INVESTMENT ADVISER ENFORCEMENT ACTIVITIES BY YEAR

	1983	1984	1985	1986	1987	Total	%
Cause inspection	16	19	14	27	4	80	28%
Public complaint	17	32	12	17	2	80	28%
Routine inspection	12	11	17	10		46	16%
Informant	12	9	9	10	1	41	14%
State/local agency	3	5	3	4	2	17	6%
Securities industry	6	1	3	1	1	12	5%
Other SEC divisions	1	2	4	1	3	11	4%
Other	7	12	5	8		32	11%
Total	76	87	65	78	13	129*	

* The total number of cases reflected in the "origins" table is larger than the actual number of enforcement actions because some cases listed more than one origin. The actual number of enforcement actions was 284. Percentages are calculated from 284 total cases for the January 1983 to July 1987 period.

Source: CATS

The table shows that the great majority of enforcement activities concerning advisers are prompted by information reaching the SEC indicating a problem with the adviser. Consistently over the years, cause inspections, public complaints, and referrals from outside the SEC (State/local agencies, the securities industry, informants) account for a large percentage of the enforcement actions. But routine inspections -- the one source of actions not based on advance indications of problems -- also generate a significant number of cases.

Table 22 discloses the number and type of cases brought by the SEC against investment advisers from January 1983 through July 1987.

Table 22

SEC INVESTMENT ADVISER ENFORCEMENT ACTIONS JANUARY 1983 THROUGH JULY 1987

Type of Action	1983	1984	1985	1986	1987	Total	%
Administrative proceedings	28	36	21	26	17	128	60
Injunctive actions	17	23	17	22	3	82	39
Civil contempt				1		1	1
Total	45	59	38	51	20	211	100

Source: SEC Docket; CATS

Table 22 shows that the annual number of enforcement actions remained relatively constant. Administrative proceedings were the most common method of enforcing investment advisers' compliance with the securities laws, with 60% of the total cases brought in this manner. Injunctions ranked next with 39%.

4. Violations alleged in cases

Table 23 shows the sorts of violations alleged against advisers in enforcement cases brought by the SEC between January 1983 and July 1987. The most common charge was fraud. 206/ In 85% of the 211 cases brought against advisers between January 1983 and July 1987, fraud was one of the charges alleged against the adviser. The second most common charge was violation of the record keeping requirements of the securities laws (35%), and the third, violation of registration requirements. As discussed above, 207/ record keeping and registration violations are by far the most common violations uncovered in the SEC's inspection program, but most of these violations result in deficiency letters, not in the institution of proceedings.

206/ For a discussion of the anti-fraud provision of the Advisers Act, see infra Appendix B.5.b.(3).

207/ See supra Chapter V.E.2.

Table 23

INVESTMENT ADVISER ADMINISTRATIVE PROCEEDINGS,
INJUNCTIVE AND CRIMINAL ACTIONS:
VIOLATIONS ALLEGED OR FINDINGS MADE BY YEAR
JANUARY 1983 TO JULY 1987

	1983	1984	1985	1986	1987 (part)	Tot.	% *
Fraud	44	53	39	45	15	197	88%
Books & records	19	23	15	15	9	81	35%
Failure to register	12	19	14	13	2	60	26%
Other**	26	18	13	28	11	96	42%

Source: SEC Docket

* Percentages equal more than 100% because many cases allege more than one violation.

** "Other" includes violations of prior injunctions; misleading statements on registration statements; conspiracy.

Table 24 discloses the type of proceeding or action brought against those charged with the three major types of violation during the same period. As the table discloses, criminal actions were brought only in a few cases, and then, only when the charge was fraud.

Table 24

INVESTMENT ADVISER ADMINISTRATIVE PROCEEDINGS,
INJUNCTIVE AND CRIMINAL ACTIONS:
VIOLATIONS ALLEGED OR FINDINGS MADE BY TYPE OF PROCEEDING
JANUARY 1983 TO JULY 1987

	Admin.	Injunct.	Crim. 208/	Tot.	% *
Fraud	91	86	20	197	85%
Books and records	55	26	--	--	35%
Failure to register	20	40	--	60	26%

* Percentages equal more than 100% because many cases allege more than one violation

Source: SEC Docket

208/ The SEC's data concerning the number of cases brought are not comprehensive because such cases are prosecuted by the Department of Justice.

VI. NASD PILOT PROJECT

A. Background

In the spring of 1986, the National Association of Securities Dealers announced a pilot program to determine the feasibility of inspecting the investment adviser activities of members. About half of the SEC registered investment advisers are "dual registrants", advisers who are registered with the SEC and are either an NASD member or associated with an NASD member. The NASD identified a group of dual registrant member firms that included both large and small firms. 209/ The NASD and the Division of Investment Management ("Division") then jointly selected NASD firms to be inspected.

Following a short (two-day) investment adviser training program for SEC and NASD inspectors participating in the pilot program, 210/ and further on-the-job training at the SEC's regional offices, NASD inspectors independently inspected 46 dually registered investment advisers of which 33 were found to be active. 211/ The NASD used their own specially developed checklist in 60% of the inspections. The SEC's inspection outline was used in the remaining 40% of the inspections. The NASD provided the Division with copies of their inspection reports.

To evaluate the NASD inspections, the SEC regional office adviser inspection staff reinspected 15 of the 33 firms that the NASD had already inspected. In order to provide a so-called "blind" comparison of SEC and NASD inspections, the SEC inspectors were not given copies of the NASD inspection reports. SEC headquarters staff then reviewed all 33 NASD reports and accompanying work papers and compared the NASD inspection results

209/ These firms had volunteered to participate in the NASD pilot inspection program. Some were financial planner firms, but the purpose of the pilot project was to measure the cost and feasibility of the NASD undertaking the program, not to inspect planner firms. Therefore, unlike the other chapters, this Chapter is not focused on financial planners. See NASD Pilot Exam Report, supra note 149.

210/ Examiners were provided with training materials, including regulations under the Investment Advisers Act, adviser registration forms, relevant adviser releases and staff interpretive letters, inspection outlines and sample inspection reports.

211/ The inspections occurred from September 1986 to April 1987.

with the results of the inspections of the 15 firms reinspected by the SEC.

B. Review of the NASD Reports

Review of the NASD inspection reports showed that NASD inspectors quickly became familiar with the Advisers Act and the basic records kept by advisers. The NASD inspectors readily identified important technical deficiencies in books and records, registrations, and advisory contracts. Many of the individual written reports showed that the NASD inspectors well understood general business practices, accounting principles, and the numerous investment products offered. While there was, inevitably, some difference in thoroughness among the inspectors, overall, the NASD inspectors covered the key inspection areas and properly documented their findings.

The amount of time NASD inspectors spent on-site seemed adequate in 29 of the 33 NASD inspections, in light of the adviser's operations and of the limited experience of the NASD inspectors in conducting adviser inspections. As to the remaining four inspections, two involved fairly large broker-dealer operations with affiliated financial planning activities; the size of these firms should have required a longer review than was conducted by the NASD inspectors. Whether a longer review would have uncovered additional deficiencies is uncertain since neither firm was one of the 15 firms that the SEC also inspected. The other two inspections were of firms the SEC also inspected. Problems found by the SEC but missed by the NASD inspectors were serious enough to warrant enforcement referrals.

The NASD inspectors did not limit their reviews solely to compliance with the regulations under the Advisers Act. They also looked for violations by advisers of the Exchange Act and the NASD's rules. It is difficult to include so many regulatory requirements in an inspection; that the NASD inspectors were able to do so at all, indicates the feasibility of expanding the NASD inspection program to cover the investment advisory activities of their members.

C. Review of SEC and NASD Dual Inspections

As noted above, for comparative purposes, 15 of the 33 active investment advisers inspected by the NASD were also independently reinspected by the SEC. Table 25 depicts the deficiencies found by the NASD and SEC using the SEC's twelve inspection focus areas.

Table 25

NUMBER OF DEFICIENCIES REPORTED BY
INSPECTION CATEGORY FOR SEC AND NASD EXAMINED FIRMS

	Examining Entity	
	NASD	SEC
Deficiencies		
Books and records	3	10
Financial matters	0	0
Registration	2	11
Custody arrangements	0	2
Investment activities	0	1
Securities transactions	0	0
Review of advisory services	0	0
Fees	2	4
Contracts	1	1
Conflicts of interest	1	7
Advertising	2	7
Correspondence	0	0
Total	11	43
Number of exams	15	15

Source: Compilation of NASD and SEC Examination Reports

The SEC reported a total of 43 deficiencies compared to 11 cited by the NASD. The explanation of the difference in the numbers is threefold. First, the NASD inspectors were inexperienced in Advisers Act inspections whereas the SEC inspectors were experienced. Secondly, the SEC typically includes as "deficiencies", practices by investment advisers that increase the risk of violations as well as those that actually are violations. Finally, many of the deficiencies noted by the SEC's examiners but not cited by the NASD consisted of violations of the more obscure, usually less significant, requirements of the Advisers Act, the kind predictably missed by inexperienced examiners. Most often they involved the adviser's failure to maintain a record of personal transactions by advisory representatives, or of the date that a copy of the firm's "brochure" was given to solicited clients. So, although the SEC reported a much higher number of deficiencies than the NASD in all categories except the category concerning fees, these numerical differences do not indicate incompetence on the NASD's part, nor was the exercise designed as a test of competence, but only of feasibility. The NASD inspectors exhibited a good understanding of the business operations and range of investment products offered by advisers.

A more serious problem is presented by the two inspections in which the SEC inspection resulted in an enforcement referral after the NASD inspection found only minor problems. In one referral, the SEC found two problems: the adviser failed to disclose to clients before a trade was made that the adviser was engaged in a principal transaction with the client, and the adviser furnished customers with misleading performance data. These activities violate the Advisers Act. In the other referral, the adviser arguably had violated the adviser's fiduciary responsibility in the allocation of directed brokerage. Although the first problem can be to some extent due to unfamiliarity with the Investment Advisers Act, the problem of directed brokerage touches on the NASD's own rules and the NASD inspectors should have caught it.

In the case of one registrant, the NASD and the SEC differed on their interpretation whether a fee-splitting arrangement, where fees were paid to a person soliciting clients for the registered investment adviser, was an arrangement subject to regulation. 212/

212/ The NASD interpreted the fee-splitting arrangement as one subject to all the applicable rule's requirements, including a requirement to disclose the arrangement to clients. The SEC examiner interpreted the arrangement to be an internal distribution of management fees not subject to the rule.
(continued...)

In summary, a review of the 15 examinations performed by both the SEC and the NASD showed that the NASD examiners had a working understanding of the Act and were able readily to identify basic or technical deficiencies relating to the SEC's key inspection focus areas. The NASD did miss important violations at two of the firms inspected, but overall, the performance of NASD inspectors was acceptable.

D. Conclusions

The results of the NASD pilot inspections showed that the NASD is capable of incorporating a compliance review of the adviser-related activities of members. Some additional training in the Advisers Act would be necessary, but there is no reason to think that NASD inspectors would fail to adapt to the regulatory scheme of the Advisers Act.

Incorporation of investment adviser inspections into the NASD's broker-dealer inspections would present a more difficult problem. Investment adviser inspections are not as number-based or generally as extensive as broker-dealer inspections. The pilot adviser inspections were not folded into regular broker-dealer inspections, nor should they have been, nor should a routine NASD adviser inspection program be merged with the NASD's routine broker-dealer inspection program. This combination of the large, quantitative broker-dealer inspections with the smaller, more subjective adviser inspections could relegate the smaller adviser inspection to a minor part of the overall inspection. If the NASD were to start inspecting the investment advisory activities of its members, procedures would have to be developed to assure that the adviser inspections are not made to compete with broker-dealer inspections for NASD examiner time in the administration of the inspection program.

A final potential problem is the inspection of NASD member firms with several branch offices. Although the branches often exhibit a high degree of autonomy from the central office, the NASD often heavily relies upon central office inspection to ensure compliance of the branch offices with the securities laws. This reliance can be misplaced. The large number of branch offices makes the cost of inspecting them on a regular basis high, but branch inspections are necessary to police adequately

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212/(...continued)
SEC headquarters staff differed with both the NASD and SEC examiner, finding that the arrangement was subject to some of the rule's requirements, but not to the disclosure requirements.

adviser activities generally, and planner activities particularly. Financial planners, because of their involvement with individual clients, are much more likely to be located in the branch offices than at the broker-dealer's main office.

APPENDIX A

History of Investment Advisers Act 1/

The Act is the last in a series of federal statutes intended to eliminate abuses in the securities industry that Congress believed contributed to the stock market crash of 1929 and the depression of the 1930s. The Act is based on a Congressionally mandated study by the SEC of investment trusts and investment companies. 2/

The SEC responded to Congress' request for a study by conducting a survey of the investment services industry as it was then constituted. The SEC also held a public conference with representatives of some of the larger investment counsel firms who testified with respect to general problems and possible regulation of investment counsel organizations.

The SEC's report 3/ as presented to Congress subsequently

1/ This discussion of the Advisers Act does not include all technical amendments to that Act.

2/ SEC Report on Investment Trusts and Investment Companies, H. Doc. No. 477, 76th Cong., 2d Sess. (1939). The SEC study and subsequent report formed the basis for the enactment of the Investment Company Act of 1940 (the "Investment Company Act"), 15 U.S.C. § 80a-1 et seq.

3/ Entitled "Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services," the supplemental report (hereinafter "SEC Report") was incidental to the SEC's main study of investment companies and was limited in scope. For example, it did not discuss publishers of impersonal investment advice, nor did it discuss the advisory activities of lawyers, accountants, or broker-dealers.

The SEC Report included appendices and tables which detailed the information that the SEC had received in response to an investment counsel questionnaire. For example, included were the following: list of investment counsel firms which replied to investment counsel questionnaire; list of investment trusts and investment companies with which investment counsel firms were affiliated at some time from January 1, 1933 to June 30, 1936; and affiliations of 56 investment counsel firms with investment company clients. The SEC Report also included state statutes with respect to investment counselors (the statutes were from California, Connecticut, Michigan, New Hampshire, Oklahoma, and Rhode Island), and a statement of the purposes and objectives of the Investment Counsel Association of America and the Investment Counsel Association of Southern California.

(continued...)

was a compilation of the views of the SEC and of industry representatives. The Report was presented to Congress in 1939. After receiving the SEC Report and holding hearings, Congress concluded that federal legislation was necessary to correct the "problems and abuses" in advisory services, 4/ and, accordingly, passed the Advisers Act. The following is a discussion of these problems and abuses as identified by industry representatives, included in the SEC Report, and then considered and credited by Congress in passing the Act.

3/(...continued)

In addition to considering the SEC Report, Congress held hearings which included testimony from, among others, members of the investment counsel industry and representatives of the SEC. Additionally, witnesses submitted documents which Congress considered. See Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 2, 726-727, 997, 1005, 1023 (1940) (hereinafter S. Hearings). The most comprehensive of these documents was a memorandum prepared by the research department of the Illinois Legislative Council, entitled "Statutory Regulation of Investment Counselors." This memorandum discussed the meaning of the term "investment counselor" and the problems with reporting a precise definition; the advantages and disadvantages of state versus federal regulation of investment advisers; which advisers should be exempt from regulation, with a section devoted exclusively to the feasibility of regulating individuals who furnish investment advice solely by means of publications; a survey of existing regulations of advisers; and an enumeration of certain practices of investment counselors which were generally recognized as the phases of investment counsel activities most subject to abuse.

4/ S. Rep. No. 1775, 76th Cong., 3d Sess. 21 (1940).

1. Investment adviser problems included in the SEC Report

a. Bona fide investment counselor vs. "tipster"

One problem in the industry, described both in the SEC Report and the legislative history of the Act, 5/ was the presence of the so-called "tipster," a person or an entity prone to making exaggerated claims and having no particular qualifications. 6/ The SEC Report and witnesses before Congress were both concerned that a distinction be made between "tipsters" and bona fide investment counsel providing personalized service based on research and experience. Many in the industry wanted to upgrade the profession and prohibit "'tipster' services which were masquerading as bona fide investment counsel." 7/

The profession of investment counselor was, itself, relatively new at the time of the Congressional hearings. Generally, prior to 1919, investment advice had been furnished by individuals and firms, "not as part of a business of servicing the investments of clients for a consideration but as ancillary to their regular business or profession. Lawyers, banks and trust companies, brokers and dealers in securities, in the course of their business furnished investment advice to their clients . . . ." 8/

However, after World War I there was a growth in the number of investment counselors unaffiliated with any other form of financial organization. 9/ Several causes were posited for this development, including that the class of investors had expanded from financial industry professionals to include private individuals who previously had been more likely to put their funds in savings banks and mortgages. 10/ Members of the existing

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5/ The SEC Report formed the basis for much of the Act's legislative history. Id. at 5.

6/ Id. at 21-22.

7/ SEC Report, supra Appendix A, note 3, at 28.

8/ Public Examination, Investment Counsel Firms, at 21638, as found in SEC Report, supra Appendix A, note 3, at 3.

9/ Id.; S. Hearings, supra Appendix A, note 3, at 724.

10/ The sale of Liberty Bonds and the post war boom in stocks generated the interest of private individuals in stock. Public Examination, Investment Counsel Firms, at 21637-40, (continued...)

investment counsel firms saw growth in the number of individual investors as a "gap in the financial picture . . . [in] that there was no agency which was solely representing the private buyer of securities." 11/ "The rise of investment counsel in the early 1920's was occasioned partly by certain weaknesses in . . . [the] investment banking system and partly by the increased complexity of the financial structure and operation of companies. A growing recognition by the investor of his difficulty in obtaining, under such conditions, competent and unbiased guidance in the management of his investments . . . caused a rapidly increasing demand for investment counsel services." 12/ The necessity for and the rapid growth of investment counsel service was due to "[a] great increase in the complexity in the numbers, and background of securities . . . available for investment." 13/ Losses experienced by investors during the depression years caused many public investors to seek continuous supervision and advice concerning their investments. 14/

A new class of "investment counsel" emerged to meet this need for unbiased investment information and guidance. These new professionals were characterized by two fundamental principles, "first, that they would limit their . . . activities to the study of investment problems from the investor's standpoint, not engaging in any other activity such as security selling or brokerage, which might directly or indirectly bias their investment judgment; and second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance."

The name 'investment counsel,' not then in use, was selected to describe both the work based on these two principles, and the persons engaged in that work." 15/

10/(...continued)
as found in SEC Report, supra Appendix A, note 3, at 4.

11/ Id.

12/ S. Hearings, supra Appendix A, note 3, at 724.

13/ Public Examination, Investment Counsel Firms, at 21672, as found in SEC Report, supra Appendix A, note 3, at 23.

14/ Public Examination, Chain Store Stocks, Inc., at 15643, as found in SEC Report, supra Appendix A, note 3, at 5.

15/ S. Hearings, supra Appendix A, note 3, at 724.

Since investment counsel were supposed to furnish unbiased, continuous, personalized advice, many industry representatives did not want investment counsel to be tainted by conflicts of interest. Industry representatives testifying before the SEC asserted that investment counsel firms should be prohibited from engaging in any business other than that of rendering investment advice. They also suggested that investment counselors be "divorced" from the directorships of corporations because of the conflicts between a director's duty to the corporation and an adviser's duty to clients who might hold securities in the corporation. 16/ Other problems identified were trading by investment counselors for their own account in securities in which their clients were interested, 17/ and affiliations between advisers and investment bankers, 18/ and advisers and brokerage houses. 19/

b. Compensation

Industry representatives also questioned the propriety of "performance fees," i.e., fees contingent upon a percentage of profits in client accounts managed by advisers. Performance fees were then the basis upon which many advisers were compensated. Industry representatives saw this compensation arrangement as inimical to the best interests of clients, because it encouraged advisers to gamble with clients' funds, taking unacceptable risks in the hope of producing larger fees if successful, with nothing to lose if not successful, except their time and their clients' assets. 20/

16/ SEC Report, supra Appendix A, note 3, at 29.

17/ Id. at 29-30.

18/ Public Examination, Investment Counsel Firms, at 21687, as found in SEC Report, supra Appendix A, note 3, at 29.

19/ Id. at 21687, as found in SEC Report, supra Appendix A, note 3, at 29.

20/ Id. at 21714, as found in SEC Report, supra Appendix A, note 3, at 30. Or, as the Senate Committee expressed it, such arrangements were of the "heads I win, tails you lose" variety and should be prohibited. S. Rep. No. 1775, supra Appendix A, note 4, at 22.

c. Solvency and custody

Before passage of the Advisers Act, investment counsel organizations 21/ were not obligated to comply with any standards designed to protect client assets in the possession of advisers. Audits of books and records and verifications of clients' funds and securities by independent accountants were neither legally required nor voluntarily done. Because many investment counsel firms were organized as corporations, the shareholders or owners of such firms were insulated from personal liability in the event that the undercapitalized firm became insolvent. 22/

d. Assignment

Another problem disclosed in the SEC's review of the advisory industry was the practice of assigning advisory agreements. Customers who selected a particular adviser in reliance on the management and policies of the person controlling the firm might find their expectations frustrated by the transfer of a controlling block of stock of the investment counsel firm to another entity without client consent. 23/ Such a transfer often resulted in the receipt of advisory services substantially different from those a client expected to obtain when it first retained the firm. 24/

21/ The SEC Report identified as investment counsel organizations those firms or departments of firms which provided investment advisory services to individuals, investment companies, banks, life insurance companies, and other insurance companies. SEC Report, supra Appendix A, note 3, at 5-8.

22/ SEC Report, supra Appendix A, note 3, at 30. While the SEC Report discussed the solvency problem, the ensuing legislation did not deal directly with financial standards for advisers but relied on general antifraud prohibitions to govern how client funds were handled. See Section 206 of the Advisers Act, as first enacted.

23/ Id. at 30.

24/ S. Rep. No. 1775, supra Appendix A, note 4, at 22. The Act, in Section 205, required contracts between advisers and clients to prohibit assignment of the advisory contract without the client's consent.

2. The Investment Advisers Act of 1940

Some but not all of the problems noted above were addressed in the original Act. The proposed original bill also contained a section attributing specific abuses to the investment advisory profession. This provision was eliminated from the final version, apparently at the urging of advisers concerned with the irreparable harm a public indictment might cause their fledgling profession. 25/

a. Provisions of the Act as originally enacted

The original Advisers Act was modest in the regulatory scheme it imposed. The Act's basic purpose was to achieve, through a regulation and reporting process, a "compulsory census" of advisers. It sought to determine the number of people engaged in the advisory business; their associations; the extent of their authority; their backgrounds; and their handling of client funds. The Act also included a few broad provisions that prohibited fraud and the embezzlement of client funds. 26/

25/ See S. Hearings, supra Appendix A, note 3, at 715-717; Securities and Exchange Comm'n v. Capital Gains Research Bureau, 375 U.S. 180, 191-92 (1963). As proposed by the SEC staff, Section 202 of the Act would have declared that the national public interest and the interests of investors are adversely affected when: (1) investors are unable to obtain adequate information as to the activities, practices, ability, training, and integrity of advisers and their associates; (2) persons of proven lack of integrity in financial matters are permitted to engage in business as advisers; (3) the compensation of advisers is based upon profit-sharing contracts and other contingent arrangements conducive to excessive speculation and trading; or (4) the business of advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients. Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, 29, 33 (1940). In contrast, the Investment Company Act of 1940 "Findings and Declaration of Policy" provision included a survey of the problems in the investment company industry that led to the enactment of that Act. Compare Section 201 [15 U.S.C. § 80b-1] of the Advisers Act with Section 1(b) [15 U.S.C. § 80a-1(b)] of the Investment Company Act. See S. Hearings, supra Appendix A, note 3, at 606, 715-717.

26/ S. Hearings, supra Appendix A, note 3, at 48.

1) Registration and reporting

To implement this "compulsory census," the Act required advisers to register with the SEC by filing an application containing specified information. 27/ Certain advisers were exempted from registration by the Act. 28/ Other persons engaging in investment advisory activities were excluded from the Act's definition of "investment adviser" and were thus not subject to any provisions of the Act. 29/ Registration could be denied or revoked if the registrant had been convicted of certain crimes within ten years of registration or had been enjoined by a court in connection with a securities or financial fraud, or if the registrant's application was materially misleading. 30/

The Act also required a registered adviser to file with the SEC annual and special reports to keep current the information in the registration application. 31/

2) Prohibited and regulated transactions

The Act went beyond a mere registration statute. It also prohibited or limited certain practices. The antifraud provision

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27/ Section 203(a) [15 U.S.C. § 80b-3(a)].

28/ Section 203(b) [15 U.S.C. § 80b-3(b)] exempted from registration (1) any adviser, all of whose clients resided in the state in which the adviser maintained his principal place of business, and who did not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange; (2) any adviser whose only clients were investment companies and insurance companies; and (3) any adviser who had fewer than 15 clients and who did not hold itself out to the public as an adviser. Subsequent amendments to this section will be discussed infra.

29/ Section 202(a)(11) [80 U.S.C. § 80b-2(a)(11)] of the Act specifically excluded from the definition of "investment adviser" the following: banks or bank holding companies, lawyers, accountants, teachers, engineers, publishers, advisers whose practice was limited to government securities, and broker-dealers whose performance of advisory functions was solely incidental to the broker-dealer business.

30/ Section 203(d) [15 U.S.C. § 80b-3(d)].

31/ Section 204 [15 U.S.C. § 80b-4].

prohibited transactions and practices which defrauded or operated as a fraud or deceit upon clients or prospective clients. 32/ A specific conflict of interest provision was included in the antifraud provision to address instances in which an adviser dealt with an advisory client as agent for another, or as a principal. 33/ "Performance fees" also were prohibited. 34/

To remedy another abuse identified in the SEC Report, the Act also prohibited the assignment of investment advisory contracts without the client's consent. 35/

3) Unlawful representations

The Act prohibited unlawful representations, including the representation or implication that any person registered under the Act had been sponsored, recommended, or had its ability or qualifications passed upon by the United States or any federal agency. 36/ In an attempt to address the "tipster" problem, 37/

32/ Section 206 [15 U.S.C. § 80b-6].

33/ Section 206(3) [15 U.S.C. § 80b-6(3)]. An adviser was prohibited from selling securities to or purchasing securities from any client, either as a principal for its own account or acting as a broker for a person other than such client, without first advising the client in writing of the capacity in which the adviser was acting in the specific transaction and obtaining the client's consent. See also Rule 206(3)-2 [17 C.F.R. 275.206(3)-2]; Investment Advisers Act Rel. No. 40 (Feb. 5, 1945). The Rule allows clients to consent in advance, i.e., give a general or blanket consent, to agency cross transactions provided that the adviser discloses such transactions by means set forth in the Rule.

34/ Section 205 (1) [15 U.S.C. § 80b-5(1)]. A performance fee bases the adviser's compensation on a share of capital gains or capital appreciation of the client's funds. The performance fees prohibition is discussed more fully infra.

35/ Section 205(2) [15 U.S.C. § 80b-5(2)]; Section 202(a)(1) [15 U.S.C. § 80b-2(a)(1)] of the Act defined "assignment" to include a transfer of a controlling block of stock in an adviser by a shareholder of such adviser. Section 205 further provided that, if the adviser is a partnership, the client must be notified of any change in membership.

36/ Section 208(a) [15 U.S.C. § 80b-8(a)].

37/ See supra Appendix A, text accompanying notes 5 to 19.

the Act also provided that no registered adviser could use the name "investment counsel" to describe the adviser's business unless it was primarily engaged in the business of rendering investment supervisory services. 38/ As discussed below, 39/ the 1960 amendments to the Act somewhat modified this prohibition.

4) Administrative and enforcement machinery

The Act's enforcement provision empowered the SEC to conduct investigations into an adviser's conduct whenever it appeared that the law was being, or was about to be, violated. The Act gave the SEC the typical investigative tools, including the power to subpoena, administer oaths and affirmations, take evidence, and require the production of any documents which were relevant and material to an inquiry. 40/ The Act also empowered the SEC to seek injunctive relief whenever the SEC determined that a violation had occurred, was occurring, or was about to occur. 41/

5) Publicity

The Act "provide[d] for confidential treatment of information obtained in the administration and enforcement of the title, to the extent that such treatment [was] consistent with efficient enforcement." 42/

38/ Section 208 [15 U.S.C. § 80b-8]. Section 202(a)(13) [15 U.S.C. § 80b-2(a)(13)] of the Act defined "investment supervisory services" as "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client." The Act thus recognized the existence of a class of advisers characterized by a personalized relationship with clients.

39/ See infra Appendix A, text accompanying notes 43 to 63.

40/ Section 209(b) [15 U.S.C. § 80b-9(b)]. The SEC could also invoke the aid of any federal court of appropriate jurisdiction to compel compliance with subpoenas.

41/ Section 209(e) [15 U.S.C. § 80b-9(e)].

42/ See Section 210 [15 U.S.C. § 80b-10]. S. Rep. No. 1775, supra Appendix A, note 4, at 23.

b. 1960 amendments

The first amendments to the original Advisers Act were passed in 1960, 43/ fifteen years after the SEC had first urged such action in a special report to Congress. 44/ To strengthen the enforcement of the Act and extend the Act's coverage, the following amendments were made:

1) Records and inspection

The Act had not required advisers to maintain books and records, nor had it authorized the SEC to examine the adviser's books and records, except pursuant to an investigation of a suspected violation of the Act. Because "[t]he prospect of an unannounced visit of a Government inspector is an effective

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43/ Investment Advisers Act-Amendments, Pub. L. No. 86-750, Sections 1-16, 74 Stat. 885 (1960).

44/ Loss, Vol. II, Ch. 8D, 1393 n.2, citing SEC, Protection of Clients' Securities and Funds in Custody of Investment Advisers (1945), summarized in Inv. Adv. Act Rel. 39 (1945). According to Professor Loss:

> A bill was introduced shortly after this report was submitted. . . . But hearings were never held. The 1957 and 1959 legislative programs . . . repeated substantially the same proposals among others. And the January 1959 report on independent regulatory commissions by the House Special Subcommittee on Legislative Oversight concluded: "It is time, in view of the increasing public reliance upon investment advisers, to strengthen the act and make it more than a mere census taking of persons in the investment advisory business." . . . Finally, most of the 1945 proposals . . . became law in late 1960. These, aside from a minor amendment of one section of the 1939 act, were the only part of the five-act legislative program of 1959 to clear the last hurdle . . . -- presumably because "This was the only bill in the Commission's legislative program which was supported without dissent by the industry."

Loss, supra Appendix A, note 44 (citations omitted) (quoting S. Rep. No. 1760, 86th Cong., 2d Sess. 2 (1960)).

stimulus for honesty and bookkeeping veracity," 45/ the Act was amended to authorize the SEC to require advisers to keep books and records as the SEC prescribed by rule, and to allow reasonable inspection by the SEC. 46/

2) Sanctions and disqualifications from registration

The Act as originally adopted provided that registration could be denied or revoked if the registrant had been convicted of certain crimes within ten years or had been enjoined by a court in connection with a securities or financial fraud, or if the registrant's application for registration was materially misleading. 47/ The Act was expanded in 1960 to allow the SEC to exclude from registration any person convicted of embezzlement, fraudulent conversion, or misappropriation of funds or securities; anyone who had violated the mail fraud statute or who was subject to any injunction based on such activities; anyone, on the basis of the SEC's findings, who had willfully violated the Securities Act of 1933 (the "Securities Act"), 48/ the Securities Exchange Act of 1934 (the "Exchange Act"), 49/ the Investment Company Act, or the Advisers Act; 50/ and any adviser who had aided, abetted, counseled, induced, or procured any person to commit the acts which were grounds for disqualification. Congress also recognized that certain similarities existed between advisers and broker-dealers, especially since both "occupations involve[d] similar delegation[s] of trust and responsibility; consequently, one banned from the latter occupation should not be allowed to enter the first." Thus, a

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45/ Amendments to the Investment Advisers Act of 1940, S. Rep. No. 1760, 86th Cong., 2d Sess. 3 (1960).

46/ Section 204 [15 U.S.C. § 80b-4]. Advisers exempt from registration under Section 203(b) were not required to keep such records, nor were they subject to inspection.

47/ Section 203(d).

48/ 15 U.S.C. § 77a et seq.

49/ 15 U.S.C. § 78a et seq.

50/ Until the 1960 amendments the SEC could not deny or revoke an adviser's registration on the basis of a finding of a willful violation of the Securities Act, the Exchange Act, the Investment Company Act, or the Advisers Act.

willful violation of the Exchange Act 51/ or the Securities Act 52/ ". . . [was made a] ground for disqualification [from registration as an adviser under the Act.]" 53/ Finally, under the original Act, if an adviser engaged in any of the activities prohibited by original section 203(d), the only sanction the SEC was empowered to impose was revocation of the adviser's registration. 54/ The 1960 amendments gave the SEC the additional power to suspend an adviser for a period not to exceed twelve months. 55/

3) Extension of antifraud provisions and rule making authority

The extension of the antifraud provisions of the Act 56/ to advisers who were not registered with the SEC, either because they failed to comply with the Act's registration requirements or because they were expressly exempted from those requirements, 57/ was one of the most significant amendments to the Act. The antifraud section was also amended to empower the SEC to promulgate rules and regulations, which would define and prescribe means reasonably designed to prevent acts and practices which were fraudulent, deceptive, or manipulative. 58/ This change was thought to be appropriate because the statutory language, while generally proscribing fraudulent and deceptive activities, had not provided for prophylactic rules designed to prevent those activities. 59/

51/ 15 U.S.C. § 78a et seq.

52/ 15 U.S.C. § 77a et seq.

53/ S. Rep. No. 1760, supra Appendix A, note 44, at 2-3.

54/ Id. at 5.

55/ Id. at 5.

56/ Section 206 [15 U.S.C. § 80b-6].

57/ Section 203(b) [15 U.S.C. § 80b-3(b)].

58/ Section 206(4) [15 U.S.C. § 80b-6(4)].

59/ S. Rep. No. 1760, supra Appendix A, note 44, at 4, 7.

4) State law

Because very few states regulated advisers in 1940, the original Advisers Act did not include a provision dealing with possible conflicts between federal and state law. 60/ In 1960, the Act was amended to provide concurrent state-federal jurisdiction in the regulation of advisers so long as no conflict existed with the Act's other provisions or accompanying rules. 61/ Concurrent jurisdiction was provided "in view of the important role which State authorities must play in the supervision of securities." 62/ Additionally, the Act was amended to make clear that information which tends to indicate a violation of state law gathered by the SEC in an inspection or an investigation could be disclosed to appropriate state officials. 63/

3. 1970 amendments

The Act was amended again in 1970. 64/ The amendments had

60/ See id. at 9.

61/ Section 222 [15 U.S.C. § 80b-22]; S. Rep. No. 1760, supra Appendix A, note 44, at 9.

62/ S. Rep. No. 1760, supra Appendix A note 44, at 9.

63/ Section 210(b) [15 U.S.C. § 80b-10(b)]; S. Rep. No. 1760, supra Appendix A, note 44, at 9. This information can only be disclosed with SEC approval.

64/ Investment Company Amendments Act of 1970, Pub. L. No. 91-547, Sections 23-26, 84 Stat. 1430, 1452-57 (1970). The advisory industry supported these amendments. See S. Rep. No. 184, 91st Cong., 1st Sess. 3 (1969). The Senate reported the events leading to the passage of these amendments:

> During the 1950's a dramatic surge of growth -- a surge that has continued to this day [1969] -- made mutual fund companies an investment medium of major significance. Therefore, in 1958 the Commission . . . authorized the securities research unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to study investment companies and to report its findings. This study, known as the Wharton report was transmitted to the Congress in August of 1962. The Wharton report assembled a wealth of factual material

(continued...)

four major effects. First, they extended the registration requirements to include advisers to investment companies. 65/ Second, they strengthened the revocation and sanction provisions by, among other things, giving the SEC the power directly to

64/(...continued)
about the mutual fund sector of the investment company business and identified what its authors believed to be the more important problems facing the industry. The report, however, made no legislative recommendations.

While the Wharton report was being prepared, the Securities and Exchange Commission was also making a detailed study of the securities industry and the securities markets. . . . Among the subjects with which this special study dealt were the sale of mutual fund shares and the special problems connected with the sale of contractual plans on the installment basis.

The Wharton and the special study reports led the SEC to make further inquiries. It presented the results of these inquiries and a detailed program for amending the act in its report on the Public Policy Implications of Investment Company Growth, transmitted to the Congress on December 2, 1966.

. . . . [Bills were introduced and hearings were held on the proposed legislation during 1967, 1968 and 1969.] As a result of these hearings many changes were made in the proposed legislation. This was due to the information derived from written and oral presentations on behalf of the Commission as well as from numerous lawyers, economists, and other individual witnesses knowledgeable in investment company matters. Testimony was also received from many representatives of the investment company industry on economic matters involved and on the regulatory problems presented.

Id. at 3-4.

65/ Section 203(b)(2) [15 U.S.C. § 80b-3(b)(2)]; S. Rep. No. 184, supra Appendix A, note 64, at 44.

sanction associated persons of an adviser. 66/ Third, they gave the SEC the power to exempt any persons or transactions from any or all provisions of the Act. 67/ Fourth, the amendments permitted registered advisers to charge investment companies and certain wealthy clients a limited type of performance fee. 68/ Finally, the Act was amended to add violations of the Investment Company Act and the failure to supervise employees as grounds for sanction. 69/

66/ Section 203(e) and (f). Additionally, the amendments gave the SEC the power to censure an adviser for, among other things, securities laws violations committed by the adviser's associated persons.

67/ Section 206A [15 U.S.C. § 80b-6A]; S. Rep. No. 184, supra Appendix A, note 64, at 46. The SEC must find that such action is necessary or appropriate in the public interest, and consistent with the protection of investors and the purposes and policies of the Act.

68/ Section 205 [15 U.S.C. § 80b-5]. Investment companies or any other client other than employee benefit plans having $1 million managed by the adviser could agree to pay a fee based on proportionate increases and decreases in the funds under management, as measured against an appropriate index of securities prices or such other measure of performance specified by the SEC. This type of fee is known as a "fulcrum fee".

69/ In creating a statutory duty to supervise, Congress also provided a safe harbor that allowed an adviser to fulfill the duty of supervision if the adviser (1) established procedures to prevent and detect violations by employees; and (2) reasonably discharged the duties and obligations imposed by such procedures without reasonable cause to believe that these procedures were not being complied with. Sections 203(e)(5) and (f) [15 U.S.C. § 80b-3(e)(5) and (f)]. The statutory duty of advisers to supervise employees is identical to the broker-dealer's duty to supervise employees [15 U.S.C. § 78o-15(b)(4)(E)].

a. 1975 amendments

Technical amendments were added to the Act in 1975. 70/ The major effect of the amendments was to require advisers to furnish books and records and other reports to clients as the SEC prescribed by rule.

b. 1976 proposed amendments

The SEC recommended amendments in 1976 to establish minimum qualification standards for persons seeking registration as advisers under the Act, and to require advisers to meet minimum financial responsibility standards. 71/ In addition, the SEC proposed elimination of the exemption from registration for intrastate advisers. The SEC also proposed creation of a statutory private right of action under the Act for clients who could allege financial damage stemming from violations of the Act by advisers. 72/ Finally, the SEC sought through the proposed legislation authority to conduct a formal study of the feasibility of establishing investment adviser self-regulatory organizations. Congress did not act on these proposed amendments. 73/

70/ Securities Acts Amendments of 1975, Pub. L. No. 94-29, Section 29, 89 Stat. 97, 166-69 (1975). The amendment to Section 204 [15 U.S.C. § 80b-4] made the definition of records under the Act consistent with the definition of records in the Exchange Act. Another technical amendment lengthened the statutory period for staff review of adviser registration statements from 30 to 45 days, and required affirmative action by SEC staff to make effective an adviser's registration. See Section 203(c)(2) [15 U.S.C. § 80b-3(c)(2)].

71/ S. 2849, 94th Cong., 2d Sess. (1976) (to amend section 208 by adding a new subsection 208(e)(1)).

72/ S. Rep. No. 910, 94th Cong., 2d. Sess. 8-9 (1976).

73/ The bill was reported out by the Senate Committee on Banking, Housing and Urban Affairs, and it included the minority views of Senator Helms and the additional views of Senator Garn. It was not reported out of the House Committee on Interstate and Foreign Commerce. See Frankel, The Regulation of Money Managers, Vol. I, Ch. 1 at 26-27; S. Rep. No. 910 supra Appendix A, note 72, at 17-23. Congressional critics of the proposed amendments stated that SEC staff did not present specific evidence demonstrating the need for adviser examination and licensing. For example, Senator Helms stated: "No evidence of need was developed at (continued...)

c. 1980 amendments

Technical changes to the Act were made in 1980 to deal with business development companies. 74/ These changes stemmed from Congressional recognition of the special purposes served by these companies, and are not of general relevance.

d. 1986 amendment

The Act was most recently amended in 1986. 75/ The sole amendment expanded the list of bases for sanctioning advisers to include: (1) convictions and injunctions related to government securities broker-dealer activities; (2) violations of the Commodity Exchange Act; 76/ and (3) activities of entities or

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73/(...continued)
the hearings or presented to the Committee by the SEC." S. Rep. No. 910, supra Appendix A, note 72, at 17.

74/ Small Business Investment Incentive Act, Pub. L. No. 96-477, Sections 201-203, 94 Stat. 2275, 2289-90 (1980). Congress recognized the recent decline in the flow of capital to American companies, and sought to reduce some of the costs of government regulation imposed on the capital raising process. Congress recognized the valuable function served by business development companies in the capital formation process, i.e., that the principal activities of business development companies consist of investing in, and providing managerial assistance to, small, growing and financially troubled businesses. Therefore, changes were made in the Act to reduce the regulatory burdens on business development companies. Additionally, the amendments facilitated the use of the Section 203(b)(3) [15 U.S.C. § 80b-3(b)(3)] exception to registration by advisers to business development companies and where the adviser was subject to registration, permitted it to charge fees based on the performance of the company. See Frankel, Vol. I, Supp. 1984, supra Appendix A, note 73 at 3; see also H. Rep. No. 1341, 96th Cong., 2d Sess. 18, 22 (1980).

75/ Government Securities Act of 1986, Pub. L. No. 99-571, Section 102(m), 100 Stat. 3208, 3220 (1986), as codified in Section 203(e) [15 U.S.C. § 80b-3(e)].

76/ 7 U.S.C. § 1-26 (1987).

persons required to register under the Commodity Exchange Act. 77/

77/ While the 1986 amendment only changed the sanctions provision relating to advisers, Section 203(e), it effectively expanded the sanctions provision for associated persons of advisers, section 203(f). Section 203(f) permits the SEC to sanction an adviser's associates for committing the same acts for which the SEC can sanction an adviser under Section 203(e).

APPENDIX B

The Operation of the Investment Advisers Act

The following is a brief description of the Act as it exists today.

1. Definition of "investment adviser" 1/

The term "investment adviser" is defined in the Act 2/ to mean any person who

- for compensation
- is engaged in the business
- of providing advice as to the value of securities or as to the advisability of investing in, purchasing or selling securities to others; or of issuing reports or analyses regarding securities.

To be an adviser under the Act's definition, a person must satisfy all three elements. These elements are discussed individually below.

a. "Compensation"

The term "compensation" has been broadly construed in SEC staff interpretive releases and "no-action" letters 3/ to include the receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, a commission, or some combination of the above. In addition, the term has been interpreted to mean that a separate

1/ Much of the discussion that follows is a paraphrase of, or is taken directly from, a recently published Advisers Act release, Investment Advisers Act Rel. No. 1092 (October 8, 1987). Release 1092 is an updated version of a similar release, Investment Advisers Act Rel. No. 770, published on Aug. 13, 1981.

2/ Section 202(a)(11). For purposes of brevity, from this point forward citations will be made to the Public Law sections of the Advisers Act, without reference to the United States Code.

3/ References infra in the form [name] (pub. avail. [date]), are to staff "no-action" interpretive letters.

fee for advisory services is not necessary. 4/ The compensation element is satisfied if either a single fee is charged for a number of services, including advisory services, or a single fee is charged for advisory services. The compensation need not be paid by the person receiving investment advice. 5/

b. The "business" standard

A person must be in the "business" of providing investment advice for compensation, but the giving of advice need not be the adviser's sole or principal business.

Whether a person giving advice about securities for compensation would be "in the business" of doing so depends upon all relevant facts and circumstances. A person is considered to be "in the business" of providing advice if the person: (i) holds himself out as an investment adviser or as one who provides investment advice, (ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the investment advice, or (iii) on anything other than rare, isolated and non-periodic instances, provides specific investment advice. 6/ For the purposes of (iii) above, "specific investment advice" includes a recommendation, analysis or report about specific securities or specific categories of securities (e.g., industrial development bonds, mutual funds, or medical technology stocks). It includes a recommendation that a client allocate certain percentages of his assets to life insurance, high-yielding bonds, and mutual funds or particular types of mutual funds such as growth stock funds or money market funds. However, specific investment advice does not include advice limited to a general recommendation to allocate assets in securities, life insurance, and tangible assets.

In applying the foregoing tests, other financial services activities offered to clients may be considered. For example, if a financial planner structures his planning so as to give only general, non-specific investment advice as a financial planner, but then gives specific securities advice in his capacity as a registered representative of a broker-dealer or as agent of an insurance company, the person would not be able to assert that he

4/ FINESCO (pub. avail. Dec. 11, 1979).

5/ Warren M. Livingston (pub. avail. Mar. 8, 1980).

6/ See Zinn v. Parish, 644 F.2d 360 (7th Cir. 1981).

was not "in the business" of giving investment advice. In the staff's view, it is necessary to consider these other financial services activities. Section 208(d) of the Advisers Act makes it illegal for someone to do indirectly under the Advisers Act what cannot be done directly.

c. "Advice about securities"

The third element of the definition is clearly satisfied if the person provides advice about, or issues reports concerning, specific securities. The more difficult questions arise when the advice is less specific. The definition has been interpreted to mean that an adviser who has not given advice about specific securities will still have given the statutory "advice about securities" by giving advice about market trends; 7/ selected statistical or historical advice; 8/ or advice in selecting and retaining an investment manager. 9/ Advice concerning the advantages of investing in, purchasing or selling securities, as opposed to, or in relation to, any non-securities investment or financial vehicle also would be "advising" others within the meaning of Section 202(a)(11).

2. Exclusions from the definition of "investment adviser"

While the definition of adviser is broad, the Act excludes six categories of persons who otherwise presumably satisfy all three elements of the definition. A person who falls within any of the exclusions is not subject to any provisions of the Act, while a person who is exempt from registration is nonetheless subject to the antifraud provisions of the Act. 10/ A person relying on an exclusion must meet all the requirements of the exclusion. The exclusions are as follows:

a. Any "bank or bank holding company"

The definition of "bank" in the Act covers a bank organized or regulated under state or federal law. This exclusion has been interpreted to mean that the following entities are not within

7/ Dow Theory Forecasts, Inc. (pub. avail. Feb. 2, 1978).

8/ Bridge Data Co. (pub. avail. May 31, 1975).

9/ FPC Securities Corp. (pub. avail. Dec. 1, 1974).

10/ State regulators retain jurisdiction over such persons.

the exclusion: a foreign bank, 11/ an adviser subsidiary of a bank holding company, 12/ a savings and loan association, 13/ and a foreign trust company. 14/

b. Any "lawyer, accountant, engineer, or teacher"

The Act also excludes from the definition of adviser four classes of professionals -- lawyers, accountants, engineers, and teachers -- so long as they provide investment advice solely incidental to the practice of their profession. 15/ The term "solely incidental" has been interpreted to mean that the exclusion will be lost if a professional holds itself out to the public as an adviser or financial planner; provides advisory services that are not reasonably related to other professional activities; or calculates advisory service charges differently from usual professional charges. 16/

11/ Letter to Congressman William J. Hughes (pub. avail. June 4, 1980).

12/ William Casey (pub. avail. June 1, 1974).

13/ Ameriway Savings Assoc. (pub. avail. Apr. 28, 1986).

14/ Brewer-Burner & Associates, Inc. (pub. avail. Feb. 7, 1974).

15/ Of course, an affiliate of a professional is not necessarily entitled to rely upon this exclusion. In two recent instances, an affiliated entity of an accounting firm did register under the Advisers Act. Seidman & Seidman established and registered a limited partnership, Seidman Financial Services, L.P., to conduct advisory and financial planning activities. Seidman & Seidman holds the only limited partnership interest in the adviser. Recently, the SEC's Division of Investment Management issued a no-action letter to Price Waterhouse under the Advisers Act to allow the firm to establish a registered investment adviser to oversee the rendering of personal financial planning services by partners and employees of Price Waterhouse, without registration of Price Waterhouse itself. Price Waterhouse is a general partner of the adviser. Price Waterhouse (pub. avail. Oct. 1, 1987).

16/ Jones & Kolb (pub. avail. May 7, 1984); David R. Markley (pub. avail. Feb. 6, 1985); Hauk, Soule & Fasani, P.C. (pub. avail. May 2, 1986).

c. Any "broker or dealer"

A broker-dealer who provides investment advice solely incidental to the conduct of business and receives no special compensation for the investment advice is also excluded from the Act. 17/ Most questions about this exclusion concern what is "special compensation." The term has been interpreted to exclude ordinary brokerage commissions from the meaning of "special compensation" unless a "clearly definable" part of the commission is for investment advice. 18/

A registered representative of a broker-dealer can use the broker-dealer exclusion if the registered representative provides advice under the supervision of and solely on behalf of the broker-dealer. A registered representative who is subject to control by an employer broker-dealer and who is providing investment advice solely on behalf of the employer thus fits within this exclusion. 19/

The SEC staff has addressed the status of securities salespersons who designate themselves as independent contractors. 20/ The issue that arises is whether the salesperson is sufficiently controlled by a broker-dealer firm to be covered by the broker-dealers' registration or whether the salesperson is not so controlled. In the latter circumstances, the person must either refrain from selling securities, or register individually as a broker-dealer. And such a person, i.e., one who sells securities but who is neither supervised by a broker-dealer nor registered as one, cannot rely on the broker-dealer shield to avoid registration as an investment adviser.

17/ The broker-dealer, however, is subject to regulation as a broker-dealer. See infra Appendix B, "Regulation of the Selling Activities of Financial Planners Who are Also, or Are Associated With, Broker-Dealers."

18/ Robert S. Strevell (pub. avail. Apr. 29, 1985).

19/ Elmer D. Robinson (pub. avail. Jan. 6, 1986); Brent A. Neiser (pub. avail. Jan. 21, 1986).

20/ See Letter from Douglas Scarff, Director, Division of Market Regulation, to Gordon S. Macklin, President, NASD (June 18, 1982). See also In the Matter of Haight & Co., Securities Exchange Act Rel. No. 9082 (Feb. 19, 1971), where the staff stated that a broker-dealer or a registered representative who employs the term "financial planner" merely as a device to induce the sale of securities might violate the antifraud provisions of the Securities Act and the Exchange Act.

d. Any publisher

Another exclusion from the term adviser covers the publisher of any bona fide newspaper or financial publication of general and regular circulation. The Supreme Court held, in 1985, 21/ that this exclusion is available to any publisher whose publication: 1) offers only impersonal advice -- advice not tailored to the individual needs of a specific client; 2) is "bona fide" -- it contains disinterested commentary and analysis rather than promotional material disseminated by a "tout" or a "tipster;" and 3) is of general and regular circulation -- it must not be timed to specific market activity or to events affecting the securities industry. The SEC staff has stated that, if a publisher voluntarily registers or remains registered, the publisher is subject to the same regulatory requirements as other advisers. 22/

e. "Government securities" advisers

This exclusion excepts any person whose advice or reports are limited to: 1) securities that are direct obligations of or guaranteed as to principal or interest by the United States; or 2) securities guaranteed by corporations in which the United States has a direct or indirect interest which have been designated by the Secretary of the Treasury as exempted securities for the purpose of the Exchange Act. 23/

f. Other persons

Finally, the SEC is allowed to exempt, by rule or order, those who are not within the intent of the adviser definition. 24/ No rules have been written under this authority, but a procedure exists that permits individuals to apply to the SEC for exemptive orders. 25/

21/ Lowe v. Securities and Exchange Comm'n, 472 U.S. 181 (1985).

22/ Vincent J. Cosentino (pub. avail. Feb. 13, 1986).

23/ Section 202(a)(11)(E).

24/ Either the SEC or the staff, through delegated authority, can issue exemptive orders. Rule 30-5(e), 17 C.F.R. § 200.30-5(e).

25/ Rule 0-5, 17 C.F.R. § 275.0-5 (1986), under the Act, and Investment Company Act Rel. No. 14492 (Apr. 30, 1985). This rule applies to applications filed under Section 206A of the
(continued...)

3. Statutory exemptions from registration

The Act requires every adviser who uses the mail or the facilities of interstate commerce in the adviser's business to register with the SEC 26/ unless exempted from registration. 27/ Any adviser relying on an exemption need not register, but is still subject to the Act's antifraud provision. 28/ Three classes of advisers are exempted from registration: 1) intrastate advisers in unlisted securities -- to qualify for this exemption the adviser must demonstrate that all clients are in the same state as the adviser's business, and that the adviser does not provide advice about exchange-listed securities; 2) advisers to insurance companies -- to qualify for this exemption all of the adviser's clients must be insurance companies; 3) "private advisers" -- to qualify for this exemption the adviser must have had fewer than 15 clients during the previous year, must not hold itself out to the public as an adviser, and must not give investment advice to a registered investment company or business development company. 29/

25/(...continued)
Act which gives the SEC broad authority to exempt any person from any or all provisions of the Act, subject to the standards described infra, Appendix B, note 29.

26/ Section 203(a).

27/ Section 203(b).

28/ Section 206.

29/ A number of common interpretive questions arise under the "private adviser" exemption. One question concerns the meaning of "holding oneself out to the public as an adviser." The SEC staff has interpreted this phrase to mean that a person "holds oneself out to the public as an adviser" when an adviser advertises, uses the label "investment adviser" on a business card or stationery, lists itself as an adviser in a telephone, business, or building directory, Dale M. Mueller (pub. avail. Feb. 20, 1984); or lets it be known generally by word of mouth that it is available to accept new clients, Peter H. Jacobs (pub. avail. Feb. 7, 1979), Richard W. Blanz (pub. avail. Jan. 28, 1985). Another frequent question is how to determine the number of the adviser's clients. Staff interpretations have stated that foreign clients should be counted the same as American clients, Walter L. Stephens (pub. avail. Nov. 18, 1985); trusts are each counted as one client, Phillip Eiseman (pub.
(continued...)

4. Registration as an investment adviser

An adviser registers with the SEC by filing a specified form, called a Form ADV, 30/ and paying a $150 registration fee. Form ADV is used by the SEC the and states that register advisers and that have adopted the form. 31/ It is a disclosure document that gives information to the SEC and the states for administrative purposes. To maintain registration in good standing, an adviser must amend Form ADV when the answers to the questions change 32/ and file a short updating statement annually.

The adviser's registration statement covers employees and those people it controls so long as their advisory activities are undertaken on behalf of the registered adviser. The adviser's employees do not have to register individually with the SEC. 33/

29/(...continued)
avail. July 22, 1976), even if they share a common trustee, OSIRIS Management (pub. avail. Feb. 17, 1984), or share some of the same beneficiaries, id; First Security Investment Management (pub. avail. Mar. 25, 1985). General partners who are advisers to a limited partnership may count the limited partners as one client, if (1) the limited partnership interests are securities, and (2) the adviser bases advice on the objectives of the partnership as a whole, not the separate interests of individual limited partners. Rule 203(b)(3)-1, 17 CFR § 275.203(b)(3)-1; Burr, Egan, Deleage & Co. (pub. avail. Apr. 27, 1987).

30/ The form is included in Appendix E.

31/ Not all states that register advisers use the Uniform Form ADV. For a discussion of state regulation of advisers, see supra Chapter V.D.2.

32/ Rule 204-1, 17 C.F.R. § 275.204-1.

33/ Persons associated with a broker-dealer registered pursuant to the Exchange Act are likewise not required to register separately with the SEC. These associated persons are required by the rules of the securities industry self-regulatory organizations, such as the New York Stock Exchange or the NASD to register with the self-regulatory organization. See, e.g., NASD Bylaws, Schedule C, Part III, Section (1)(a).

a. Part I of Form ADV

This part of the form is primarily for regulatory use. 34/ It contains information such as the adviser's trade name, who controls the adviser, how the adviser's operations are financed, the states in which the adviser is registered, whether the adviser maintains custody of clients' assets, a description of the ownership of the adviser, the number and size of the adviser's discretionary and non-discretionary accounts, and whether the adviser has been involved in material civil or criminal litigation. The registrant is also supposed to disclose on this part of the form whether or not it is a financial planner.

b. Part II of Form ADV

This part of the form contains information that must be given to the client and is primarily for the client's use. 35/ It calls for disclosure of whether the adviser calls any of the adviser's services "financial planning"; the types of advisory services provided; the advisory fees charged; how securities are analyzed; the adviser's affiliations with other securities professionals; whether the adviser effects securities transactions for advisory clients; whether the adviser has brokerage or investment discretion for clients; and a description of the adviser's education and business background. 36/ An adviser who has custody or possession of client assets or who requires certain prepayments of advisory fees is also required to include a balance sheet, which must be audited.

c. Procedure for declaring Form ADV effective

Within 45 days after the filing of the Form ADV, the SEC must either grant the adviser's registration by order or institute proceedings to deny registration. 37/

34/ Both Part I and Part II of registered advisers' Form ADV are available for public inspection and copying in the SEC's Public Reference Room.

35/ Rule 204-3, 17 C.F.R. § 275.204-3. This requirement is part of the "brochure rule" which is discussed infra Appendix B, text accompanying notes 62 to 63.

36/ The Act does not, however, require any particular educational or business background for registration.

37/ Rule 203(c)(2), 17 C.F.R. § 275.203(c)(2). The SEC may deny the registration of any applicant on any of the same bases
(continued...)

5. Regulation of registered investment advisers

The Act subjects registered investment advisers to administrative oversight by the SEC, including the prospect of periodic inspections by SEC examiners and the institution of administrative proceedings against the adviser for violations of the Act. The Act also imposes on advisers: (1) a fiduciary duty to clients; (2) certain substantive obligations; and (3) record-keeping requirements. These will be discussed in turn.

a. Fiduciary duty to clients

Fundamental to the Act is the idea that an adviser owes clients certain fiduciary obligations. The Supreme Court has held that the Advisers Act reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," 38/ and that Section 206 of the Act establishes "federal fiduciary standards to govern the conduct of investment advisers." 39/ Additionally, the Supreme Court has recognized that "the Act's legislative history leaves no doubt that Congress intended to impose [on advisers] enforceable fiduciary obligations." 40/ The Supreme Court has described the adviser's fiduciary duty as including "'an affirmative duty of utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." 41/

The Act's imposition on the adviser of a fiduciary duty to clients is intended to eliminate conflicts of interest and to

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37/(...continued)
that it may revoke an adviser's registration, including false or misleading statements in the application for registration, any securities-related convictions, injunctions, or similar offenses. See Section 203(e).

38/ SEC v. Capital Gains, 375 U.S. 180, 191 (1963) (quoting 2 Loss, Securities Regulation 1412 (2d ed. 1961)).

39/ Transamerica Mortgage Advisers v. Lewis, 444 U.S. 11, 17 (1979) (citing, quoting Santa Fe Industries v. Green, 430 U.S. 462, 471, n.11 (1977); Burks v. Lasker, 441 U.S. 471, 481-82, n.10 (1979); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963)).

40/ Transamerica, 444 U.S. at 17.

41/ Capital Gains, 375 U.S. at 194.

prevent the adviser from overreaching or taking unfair advantage of a client's trust. An adviser, as a fiduciary, owes clients more than honesty and good faith alone. An adviser must also be sensitive to the possibility of rendering less than disinterested advice whether consciously or unconsciously, and an adviser may be faulted even where it did not intend to injure the client and even if the client does not suffer a monetary loss. 42/

The SEC has stated that an adviser's duty to have a reasonable, independent basis for investment advice flows from the fiduciary relationship with the client. 43/ Other fiduciary obligations placed on the adviser include the adviser's duty to obtain best execution for the client's securities transactions; 44/ to ensure that the investment advice rendered is suitable to the client's objectives, needs, and circumstances; 45/ and to be loyal to the client. 46/

b. Substantive provisions

The registration scheme of the Act is complemented by a few substantive provisions: these include prohibitions on performance fees; requirements of certain disclosures related to conflict of interest or past disciplinary actions; prohibitions against fraud; regulation of adviser advertising, of the adviser's custody of client funds or securities, and of the solicitation of advisory clients requirements concerning delivery of a disclosure document to advisory clients (the "brochure rule"); and requirements concerning an adviser's responsibility to supervise employees.

42/ See Capital Gains, 375 U.S. at 188, 195.

43/ See In the Matter of Alfred C. Rizzo, Investment Advisers Act Rel. No. 897 (Jan. 11, 1984).

44/ An adviser must engage in brokerage practices that are in the client's interest. See Rule 206(3)-2(c), 17 C.F.R. § 275.206(3)-2(c); Interfinancial Corp. (pub. avail. Mar. 18, 1985).

45/ See In the Matter of John G. Kinnard and Co., Inc. (pub. avail. Nov. 30, 1973).

46/ Investment Advisers Act Rel. No. 40 (Feb. 5, 1945); Investment Advisers Act Rel. No. 232 (Oct. 16, 1968).

1) Performance fees: Section 205(1)

As discussed above, one concern that led to the passage of the Act was the compensation arrangement between an adviser and client known as a "performance fee." 47/ A performance fee ties the adviser's compensation to the capital gains or appreciation of a client's funds. 48/ Congress prohibited this method of compensation because of the potential for encouraging advisers to seek the maximum gain by taking the maximum risk with a client's assets. Any fee that is contingent upon some level of investment performance is generally considered to be a performance fee and therefore unlawful. 49/

2) Agency cross and principal transactions: Section 206(3) and Rule 206(3)-2

Section 206(3) regulates principal transactions and agency cross transactions. Principal transactions occur when the adviser sells securities it owns to the client or buys them from the client for its own account. Agency cross transactions occur when an adviser acts as broker to both the advisory client and the opposite party to the transaction. The Act prohibits these transactions, unless the adviser discloses to clients in writing before each transaction the capacity in which the adviser is

47/ See supra Appendix A, text accompanying note 20.

48/ Section 205(1).

49/ See Investment Advisers Act Rel. No. 721 (May 16, 1980). There are two exceptions to the prohibition, one under the Act, and one by rule. The Act excepts "fulcrum fees" for investment companies or those with $1 million in assets. These fees are based on the asset value of the managed fund averaged over a specified period, and must increase or decrease proportionately with the investment performance of the managed funds in relation to an appropriate index of securities prices. The second exception to the prohibition was codified in Rule 205-3, 17 C.F.R. § 275.205-3 under the Act and allows a performance fee if: the client has at least $500 thousand under management and a net worth that exceeds $1 million; compensation is based on a formula including capital gains less losses in the client's account for a period of a year; the adviser reasonably believes that the client understands the risks involved; and specified disclosures are made.

acting. The client must consent to principal transactions and agency cross transactions. 50/

The SEC has, by rulemaking, created a blanket exemption for agency cross transactions, but not for principal transactions. Pursuant to Rule 206(3)-2, 51/ the cross-transaction exemption is available if the adviser discloses the capacity in which it is acting and possible conflicting loyalties; sends the client written confirmations of each transaction and an annual statement of all agency cross transactions; and allows the client to revoke at any time the authority granted the adviser.

3) Antifraud provisions: Section 206

A third substantive provision of the Act is the antifraud provision, which makes it unlawful for any adviser, using the mails or the facilities of interstate commerce, to engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative, 52/ and gives the SEC authority to define and prescribe these kinds of acts and means reasonably designed to prevent their occurrence. This provision is broader than Rule 10b-5 under the Exchange Act, 53/ because it does not require the fraud to be in connection with the purchase or sale of a security. The Act's antifraud provision cannot be used by private parties because the Supreme Court has interpreted the Advisers Act to deny the existence of private rights of action under the Act. 54/

The SEC has adopted four rules under the antifraud provision. These rules deal with advertising, custody of clients' assets, solicitation of clients, and disclosure of adverse financial conditions and certain disciplinary events.

50/ Investment Advisers Act Rel. No. 40 (Feb. 5, 1945).

51/ 17 C.F.R. § 275.206(3)-2.

52/ Section 206.

53/ 17 C.F.R. § 240.10b-5.

54/ See Transamerica, 444 U.S. at 24. A limited private right of action exists under Section 215, the contract provision, for rescission (or an injunction against continued operation) of the advisory contract, coupled with restitution of money paid thereunder. Id. at 18-19.

a) Adviser advertising: Rule 206(4)-1

The advertising rule proscribes certain advertising practices as fraudulent, but also generally proscribes any false or misleading statements in an advertisement. 55/ More specifically proscribed are testimonials; 56/ past profitable recommendations, unless the adviser includes a list of all of the past year's recommendations; 57/ representations that a graph, chart, or formula can in and of itself be used to determine which securities to buy or sell; 58/ and advertisements that falsely portray a service as free. 59/

b) Custody of client assets: Rule 206(4)-2

The SEC adopted the custody rule 60/ to deal with advisers who have custody or possession of the funds or securities of their clients. The rule requires all securities of each client to be segregated and all funds of each client to be deposited in a bank account which contains only client funds. A separate record must be maintained for each such account; disclosure must be made to each client of how the client's assets will be kept; a quarterly statement itemizing all debits and credits to the account must be sent to each client; and a surprise audit must be conducted by an independent public accountant once a year. This rule does not apply to an adviser registered as a broker-dealer under the Exchange Act if such person is in compliance with the net capital requirements of the Exchange Act or is a member of an exchange whose members are exempt from the Act's custody rule.

c) Solicitations: Rule 20[illegible]4)-3

This rule makes it unlawful for an adviser to pay a cash fee to a person who solicits clients for the adviser unless (1) the

55/ Rule 206(4)-1, 17 C.F.R. § 275.206(4)-1. Paragraph (5) of that rule is a catch-all provision which prohibits any advertisement containing any untrue statement of material fact or which is otherwise false or misleading.

56/ Rule 206(4)-1(a)(1), 17 C.F.R. § 275.206(4)-1(a)(1).

57/ Rule 206(4)-1(a)(2), 17 C.F.R. § 275.206(4)-1(a)(2).

58/ Rule 206(4)-1(a)(3), 17 C.F.R. § 275.206(4)-1(a)(3).

59/ Rule 206(4)-1(a)(4), 17 C.F.R. § 275.206(4)-1(a)(4).

60/ Rule 206(4)-2, 17 C.F.R. § 275.206(4)-2.

adviser is registered; (2) the solicitor is not subject to court order or administrative sanction; and (3) the fee is paid pursuant to a written agreement which makes certain disclosures designed to apprise potential advisory clients of the solicitor's interest in promoting the adviser. 61/

d) Financial and disciplinary disclosures: Rule 206(4)-4

The SEC recently adopted Rule 206(4)-4 to codify case law and SEC interpretive positions that held that advisers have a duty to disclose to clients the precarious financial condition of the adviser or prior disciplinary events. Under the rule --

(a) advisers with custody or discretionary authority over client assets or who require substantial prepayment of advisory fees must promptly disclose to clients or prospective clients all material facts with respect to a financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients;

(b) all advisers must disclose to clients any disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients; and

(c) the rule creates a presumption that for ten years subsequent to the event, certain enumerated disciplinary events are material. These include adverse civil and criminal court actions generally involving fraud or theft, and administrative or self-regulatory organization proceedings involving findings of violations of securities or other investment-related laws and the imposition of significant sanctions.

4) "Brochure rule": Rule 204-3

The brochure rule requires registered advisers to provide to clients the same information required in Part II of Form ADV. 62/ Many advisers simply provide Part II, while others put that

61/ Rule 206(4)-3, 17 C.F.R. § 275.206(4)-3.

62/ Rule 204-3, 17 C.F.R. § 275.204-3. The contents of Part II of Form ADV were discussed supra Appendix B, text accompanying notes 35 to 36.

information into a disclosure statement, or brochure. The brochure must be delivered at least two days before the advisory contract is entered into or at the time the contract is entered into if the client has a right to terminate the contract without penalty within five days of entering into the contract. The adviser also must provide or offer to provide an updated brochure annually. 63/

5) Duty of supervision: Section 203(e)(5)

Registered advisers have a continuing duty to supervise and be responsible for anyone acting on their behalf. 64/

A recent SEC order under this provision of the Act was entered in the matter of Stein Roe & Farnham. 65/ The SEC found that the adviser had failed to reasonably supervise a senior partner with a view to preventing violations of Section 206 of the Advisers Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, thereby violating Section 203(e)(5) of the Advisers Act. Among other matters, the SEC found several weaknesses in the adviser's internal control system, including the absence of a check on a partner's selection of firms to which to allocate the brokerage generated by managed accounts. The adviser also failed to have adequate controls to question transactions which did not follow the adviser's usual procedure for placing of client transactions, and it did not document the reason for purchasing securities not on the adviser's recommended list. The SEC, among other things, required that the adviser engage an independent consultant to review the adviser's supervisory and compliance procedures.

c. Recordkeeping requirements: Rule 204-2

The Act generally requires an adviser to maintain two types of books and records: (1) the typical accounting records that any business would normally keep, such as check books, written agreements with clients, bills, and financial statements; and (2) other records that the SEC believes are necessary in light of the adviser's fiduciary duty, such as the adviser's personal securities transactions, orders by clients, advertisements, and

63/ Rule 204-3(c), 17 C.F.R. § 275.204-3(c).

64/ Section 203(e)(5); Justin Federman Stone, 41 S.E.C. 717 (1963); TBA Financial Corp. (pub. avail. Dec. 7, 1983).

65/ Securities Exchange Act Rel. No. 23640 (Sept. 24, 1986).

the adviser's brochure. 66/ Additional records are required of advisers who have custody of client funds or securities, or of those who provide investment supervisory services. 67/ The records must be retained for five years, 68/ and they can be kept on hard copy, microfilm, or computer. 69/

6. Administrative oversight

a. Inspection 70/

The SEC's regional and branch offices perform most of the SEC's inspections of advisers. 71/ There are two types of inspections: routine and "for cause." In both types, SEC staff review on site the adviser's books and records and conduct interviews with adviser personnel. "For cause" inspections are based on public complaints, rumors of trouble, or tips. Routine inspections are done under broad policy guidelines set by the SEC's Division of Investment Management. Inspectors look particularly for evidence of churning (excessive trading); scalping, i.e., the adviser's trading on short-term market activity caused by the adviser's recommendations; brokerage practices not in the client's interest, i.e., the failure to obtain best execution; unsuitability, i.e., the adviser's recommendations that are unsuitable for a client's investment objectives; deceptive advertising; and improper recordkeeping. Inspectors also look to see whether the adviser's disclosures to customers are accurate.

If important problems are uncovered during an inspection, the staff will either send a "deficiency letter" to the adviser detailing the problems found, with a request that the adviser take corrective steps, or, for more serious problems, will refer the matter to the SEC's enforcement staff for further investigation.

66/ Rule 204-2, 17 C.F.R. § 275.204-2.

67/ Rule 204-2(b), and (c), 17 C.F.R. § 275.204-2(b) and (c).

68/ Rule 204-2(e), 17 C.F.R. § 275.204-2(e).

69/ Rule 204-2(g), 17 C.F.R. § 275.204-2(g).

70/ For a more comprehensive discussion of the SEC's inspection program, see Chapter V.E.

71/ The SEC has 9 regional offices and 5 branch offices.

b. Enforcement

The SEC has several formal means to enforce the provisions of the Act. Administrative proceedings 72/ can be brought against an adviser who has been permanently or temporarily enjoined from acting as a securities professional or who has been enjoined for violating the federal securities laws or assisting in such a violation. Additionally, administrative proceedings can be brought against an adviser who has violated any provisions of the Securities Act, the Exchange Act, the Investment Company Act, the Advisers Act, the rules of the Municipal Securities Rulemaking Board, the Commodity Exchange Act, or any of the rules or regulations under any of those statutes or provisions. An administrative proceeding can also be initiated against an adviser for: (1) inclusion of false or misleading statements in an application for registration or a report filed with the SEC; and (2) convictions for any felony or misdemeanor involving the purchase or sale of securities, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense. 73/ Finally, convictions for larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or

---

72/ Most SEC administrative proceedings are settled by consent. A contested administrative proceeding consists of a hearing before an independent SEC employee known as an administrative law judge and is generally conducted in a manner similar to a non-jury trial, with the SEC's staff and the adviser-respondent each having the right to present evidence and testimony and to cross-examine witnesses. The administrative law judge makes an initial decision which includes findings of fact and conclusions of law. This decision may be reviewed by the SEC either on petition of one of the parties or on the SEC's own initiative. Sanctions available in an administrative proceeding include censure, limitations on the registrant's activities, or revocation of registration.

Any party aggrieved by a final order entered in an SEC administrative proceeding may obtain review of the order in the United States Court of Appeals for the District of Columbia or the circuit in which the party resides or has a principal place of business.

73/ The conviction must have been within ten years preceding the filing of a registration application or at any time thereafter. Section 203(e)(2).

misappropriation of funds or securities are grounds for initiation of administrative proceedings. 74/

In addition to conducting administrative proceedings, the SEC has statutory authority to initiate an action in a federal district court to enjoin violations of the securities laws by any person. 75/ Willful violations of the securities laws or the rules promulgated under them are punishable by fine and imprisonment. 76/ The SEC does not prosecute criminal cases itself, but transmits the evidence to the Department of Justice, which decides whether to prosecute and pursues the prosecution.

An individual barred from association with an adviser may later apply to the SEC for relief from the bar. 77/ The applicant must show that the proposed association is in the public interest and must address certain events occurring subsequent to the SEC's bar. 78/ The applicant also must describe the capacity in which it will be associated with the adviser, and SEC staff must find that the proposed association will be consistent with the public interest. 79/

74/ The statutory provisions pursuant to which proceedings may be brought against an adviser are in Section 203(e) of the Advisers Act. Enforcement action can also be taken against an associated person of an adviser who has committed any of the prohibited activities enumerated in Section 203(e). See Section 203(f).

75/ Section 209.

76/ Id.

77/ See Rule 29 of the SEC's Rules of Practice and Investigations, 17 C.F.R. § 201.29]. Some orders instituting a bar provide a right to reapply after a specified period of time. The SEC generally will grant such applications upon a proper showing made after expiration of the specified period.

78/ Included are: 1) the time elapsed since imposition of the bar; 2) any action taken to recompense any person injured by the applicant's misconduct; 3) applicant's compliance with the order; and 4) applicant's employment record since the bar.

79/ In these circumstances, the SEC is especially concerned with the amount of supervision to be exercised over the applicant and by the applicant.

7. Regulation of the Selling Activities of Financial Planners Who Are Also, or Are Associated With, Broker-Dealers

Financial planners, including those who are exempt from registration as investment advisers, may be subject to federal regulation as broker-dealers if their activities bring them within the definition of broker or dealer under the federal securities laws, 80/ or if they are employees of, or associated with, 81/ entities coming within that definition. Registered broker-dealers, and their associated persons, are subject to a comprehensive regulatory scheme designed to ensure that the customers are treated fairly, that they receive adequate disclosure, and that the broker-dealer is financially capable of transacting business.

An exhaustive discussion of the regulation of broker-dealers and their associated persons is beyond the scope of this report. It may be helpful, however, to give a brief overview of those provisions of the federal securities laws that are relevant to the selling practices of financial planners who, because they also sell securities to their customers, must be registered as broker-dealers or as representatives of broker-dealers.

80/ Section 3(a)(4) of the Exchange Act, 15 U.S.C. § 78c-3(a)(4), defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Section 3(a)(5), 15 U.S.C. § 78c-3(a)(5), defines "dealer" as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business." [Hereinafter references to the Exchange Act will be to the Public Law section, not to the United States Code.]

81/ Exchange Act Section 3(a)(18) defines, in part, "person associated with a broker or dealer" or "associated person of a broker or dealer", as:

> any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer . . . .

a. Supervision of sales activities

Broker-dealers are required by federal law 82/ and by the rules of self-regulatory organizations 83/ (to which all broker-dealers must by law belong 84/), to maintain reasonable supervision over the activities of their employees for the purpose of preventing violations of the federal securities laws. It is not sufficient for the broker-dealer to have written procedures; the procedures must also be implemented. Under the law, no person who has imposed and followed reasonable procedures in the execution of supervisory responsibilities may be charged with failure to supervise. The emphasis is on reasonable controls and reasonable efforts. In addition, individuals responsible for management and supervision must pass qualifying examinations that test understanding of the laws, rules and regulations that pertain to sales activities. 85/

b. Competency standards for persons who sell securities

The Exchange Act, unlike the Advisers Act, imposes on broker-dealers and their associated persons "standards of training, experience, competence" and other qualifications the SEC deems appropriate. 86/ Pursuant to this mandate, self-regulatory organizations have established qualifying standards

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82/ Exchange Act Section 15(b)(4)(E).

83/ The NASD, for example, has explicit rules regarding the duty to supervise. See NASD Rules of Fair Practice, Art. III, Section 27, NASD MANUAL (CCH) paragraph 2177. Section 27(a) states as follows:

> Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of [the NASD].

84/ See Exchange Act Section 15(b)(8).

85/ See, e.g., NASD By-laws, Schedule C, NASD MANUAL (CCH) paragraph 1753, II, "Registration of Principals".

86/ Exchange Act Section 15(b)(7).

for members and associated persons. 87/ Qualifying examinations test knowledge of products that are sold, of the markets in which products are sold, and of the laws, rules and regulations that govern sales activities.

c. Suitability standards

A critical element in a broker-dealer's obligation to deal fairly with its customers is that recommendations regarding securities transactions made to customers by the broker-dealer or its registered representatives be suitable in light of the customer's financial resources, sophistication, and investment objectives. The NASD, to which the vast majority of broker-dealers and registered representatives engaged in retail sales belong, has a "suitability" rule which states:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and to his financial situation and needs. 88/

The SEC has upheld, and federal courts have affirmed, disciplinary actions taken against broker-dealers and their securities sales representatives for making unsuitable recommendations to clients. 89/

The New York Stock Exchange and the American Stock Exchange impose on member firms the obligation to use "due diligence to learn the essential facts relative to every customer". 90/ This "know your customer" requirement is also regarded as a basis for protecting customers against unsuitable recommendations.

87/ See, e.g., NASD By-laws, Schedule C, NASD MANUAL (CCH) paragraph 1753, for the NASD requirements. Most individuals who sell securities must pass the Test Series 7 examination. Schedule C, III.

88/ NASD Rules of Fair Practice, Art. III, Section 2, NASD MANUAL (CCH) paragraph 2152.

89/ See, e.g., Eugene J. Erdos, Exchange Act Rel. No. 20376 (Nov. 16, 1983).

90/ Rule 405, 2 NYSE GUIDE (CCH) paragraph 2405; Rule 411 ASE GUIDE (CCH) paragraph 9431.

d. Regulation of advertising and sales literature

Self-regulatory organizations have established guidelines regarding the content and review of advertisements and sales literature. The NASD, for example, requires that all sales literature and advertisements be approved in advance, in writing, by a member of the broker-dealer firm's management. 91/ The NASD also requires that certain advertisements be submitted to the NASD before use, 92/ and that all communications with the public be "based on the principles of fair dealing and good faith." 93/ Statements that are false, misleading, untrue as to material fact, exaggerated, or unwarranted, are prohibited. 94/

e. SEC and self-regulatory organization record-keeping and inspection program

The Exchange Act and the rules promulgated thereunder impose on broker-dealers a comprehensive scheme of record-keeping and maintenance. 95/ Included in the records broker-dealers are required to make or maintain are customer account agreements, customer account statements, communications with customers, and margin agreements. 96/ In addition, the SEC and the self-regulatory organizations conduct periodic and surprise inspections of broker-dealers to assure compliance with the record-keeping and other rules and regulations, including those requirements that pertain to sales practices. 97/

91/ NASD Rules of Fair Practice, Section 35(b)(1), NASD MANUAL (CCH) paragraph 2195.

92/ E.g., NASD Rules of Fair Practice, Section 35(c)(1), (2), NASD MANUAL (CCH) paragraph 2195 (advertisements pertaining to options).

93/ Id. at Section 35(d)(1)(A).

94/ Id. at Section 35(d)(1)(B).

95/ See generally Exchange Act Section 17(a)(1).

96/ See generally Exchange Act Rule 17a-3, 4, 17 C.F.R. § 240.17a-3, 4.

97/ See generally Exchange Act Sections 17(b), 17(d).

APPENDIX C

NINETY-NINTH CONGRESS

U.S. House of Representatives

SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION AND FINANCE
OF THE
COMMITTEE ON ENERGY AND COMMERCE
WASHINGTON, DC 20515

July 9, 1986

CHAIRMAN'S OFFICE
RECEIVED
JUL 10 1986
SEC. & EXCH. COMM.

The Honorable John S.R. Shad
Chairman
The Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Shad:

Thank you for testifying before the Subcommittee at our recent hearing on investment advisers and financial planners. We greatly appreciate your efforts to help the Congress better understand the complicated and important issues discussed at the hearing.

It was clear at the hearing that all of the witnesses, including the investors, industry associations and regulators, shared a concern with the Subcommittee Members about the harm to investors caused by unscrupulous investment advisers and financial planners. However, there clearly was no consensus as to the scope of the problem or the possible solution. Consequently, we would ask that you coordinate and supervise a comprehensive study to examine the current status of the industry and the degree of abuse. The following issues should be included in the scope of the study:

(1) customer demographics - What are the demographic characteristics of financial planner/adviser customers? Are the customers individuals or institutions? If the customers are individuals what is their:
- o income level,
- o educational background,
- o reason for seeking financial advice generally and for selecting a particular planner/adviser, and
- o previous financial experience?

(2) planner/adviser characteristics - What are the characteristics of financial planners or advisers? What is their:
- o size (e.g., their number of employees, customers, offices and states of operation);
- o background (e.g., their education, experience and qualifications);
- o other business activities (e.g., are they a broker-dealer, insurance agent, banker, accountant, etc.); and
- o custody of, or discretionary authority over client funds and the amount of funds involved?

(3) compensation of planners/advisers - Is the financial planner/adviser compensated for services by a flat fee or by a commission? If compensation is by commission:
- o what is the type and number of products offered; and
- o what level of disclosure do planners/advisers provide concerning their interest in the products they sell -- financial or otherwise?

(4) registration - With what state or federal regulatory authorities or self-regulatory organizations are financial planners registered? Do the financial planners:
- o file reports,
- o submit to inspections or otherwise communicate with authorities or organizations

(5) examinations/inspections - What level of examinations are financial planners/advisers subjected to? What is the:
- o amount of time before the first inspection and between subsequent inspections,
- o number of existing uninspected planners/advisers,
- o result of inspections,
- o number and kind of violations,
- o number and outcome of cases brought, and
- o method of detecting violations (i.e., is detection the result of a scheduled inspection or a customer complaint)?

(6) What is your evaluation of the NASD pilot program?

We understand that this is an ambitious agenda given the difficulty in obtaining information and limited SEC resources. However, we encourage you to utilize the various relevant trade and regulatory associations and organizations to the fullest extent possible. It is particularly important that the Commission work together with the state securities officials.

Because of the importance of this subject, we request that the Commission staff work with the Subcommittee staff in providing an outline and a plan for gathering information. We would appreciate your informing us within 30 days of how the Commission proposes to conduct the study and providing us with an outline of what will be covered.

With best wishes,

Sincerely yours,

Matthew J. Rinaldo
Ranking Minority Member

Timothy E. Wirth
Chairman

APPENDIX D

Glossary of Terms

AICPA	Association of Independent Certified Public Accountants
ASCLU	American Society of Certified Life Underwriters
CFA	Chartered Financial Analyst
CFA	Consumer Federation of America
CFP	Certified Financial Planner
ChFC	Chartered Financial Consultant
CLU	Certified Life Underwriter
CPA	Certified Public Accountant
FAF	Financial Analysts Federation
IAFP	International Association of Financial Planners
IBCFP	International Board of Standards and Practices for Certified Financial Planners
ICAA	Investment Counsel Association of America
ICFP	Institute of Certified Financial Planners
ICI	Investment Company Institute
JD	Juris Doctor degree
LLM	Master of Laws degree
NALU	National Association of Life Underwriters
NAPFA	National Association of Personal Financial Advisors
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
RIA	Registered Investment Adviser
SRO	Self-Regulatory Organization

APPENDIX E

OMB APPROVAL
OMB No.: 3235-0049
Expires: June 30, 1988

FORM ADV INSTRUCTIONS

1. **This is a Uniform Form for use by investment advisers to:**
   - register with the Securities and Exchange Commission and the jurisdictions that require advisers to register.
   - update those registrations. When updating, complete all amended pages in full and circle the number of the item being changed. Each amendment must include the execution page.
2. **Organization**

   The Form contains two parts. Parts I and II are filed with the SEC and the jurisdictions; Part II can be given to clients to satisfy the brochure rule. The Form also contains the following schedules:
   - Schedule A — for corporations;
   - Schedule B — for partnerships;
   - Schedule C — for entities that are not sole proprietorships, partnerships or corporations;
   - Schedule D — for reporting information about individuals under Part I Items 11 and 12;
   - Schedule E — for continuing responses to Part I items;
   - Schedule F — for continuing responses to Part II items; and
   - Schedule G — for the balance sheet required by Part II Item 14.
3. **Format**
   - Type all information.
   - Give all individual names in full, including full middle names.
   - Use only Form ADV and its Schedules or a reproduction of them.
4. **Signature**
   - All filings and amendments must be filed with a signed execution page (page 1).
   - Each copy filed with the Securities and Exchange Commission and any jurisdiction must be manually signed.

If applicant is	Form ADV should be signed by
• a sole proprietor	the proprietor
• a partnership	a general partner for the partnership
• a corporation	an authorized principal officer for the corporation
• any other organization	the managing agent (an authorized person that participates in managing or directing applicant's affairs)

5. **General Definitions** (Additional definitions appear in Part I Item 11 and Part II.)
   - Applicant — The investment adviser applying on or amending this Form.
   - Client — An investment advisory client of the applicant.
   - Control — The power to direct or cause the direction of the management or policies of a company, whether through ownership of securities, by contract, or otherwise. Any individual or firm that is a director, partner or officer exercising executive responsibility (or having similar status or functions) or that directly or indirectly has the right to vote 25 percent or more of the voting securities or is entitled to 25 percent or more of the profits is presumed to control that company. (This definition is used solely for the purpose of Form ADV.)
   - Custody — A person has custody if it directly or indirectly holds client funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them. An adviser has custody, for example, if it has a general power of attorney over a client's account or has signatory power over a client's checking account. (The definition and examples are for the convenience of registrants. Depending on the facts and circumstances, other situations also may involve custody.)
   - Jurisdiction — Any non-Federal government or regulatory body in the United States, or Puerto Rico.
   - Person — An individual, partnership, corporation or other organization.
   - Related person — Any officer, director or partner of applicant or any person directly or indirectly controlling, controlled by or under common control with the applicant, including any non-clerical, non-ministerial employee.
   - Self-regulatory organization — Any national securities or commodities exchange or registered association, or registered clearing agency.

6. **Continuation Sheets** — Schedules E and F provide additional space for continuing Form ADV items (Schedule E for Part I; Schedule F for Part II) but not for continuing Schedules A, B, C, D or G. To continue those schedules, use copies of the schedule being continued.

7. **SEC Filings**

   - Submit filings in triplicate to the U.S. Securities and Exchange Commission, Washington, D.C. 20549. To register, submit a check or money order for $150 payable to the U.S. Securities and Exchange Commission. This fee is non-refundable. There is no fee for amendments.
   - **Non-Residents** — Rule 0-2 under the Investment Advisers Act of 1940 [17 CFR 275.0-2] covers those non-resident persons named anywhere in Form ADV that must file a consent to service of process and a power of attorney. Rule 204-2(j) under the Investment Advisers Act of 1940 [17 CFR 275.204-2] covers the notice of undertaking on books and records non-residents must file with Form ADV.
   - **Updating.** Federal law requires filing amendments:
     — promptly for *any* changes in:
     Part I — Items 1, 2, 3, 4, 5, 8, 11, 13A, 13B, 14A, and 14B;
     — promptly for *material* changes in:
     Part I — Items 9 and 10 and all items of Part II except Item 14;
     — within 90 days of the end of the fiscal year for any other changes.
   - **Federal Information Law and Requirements** — Investment Advisers Act of 1940 Sections 203(c), 204, 206, and 211(a) authorize the SEC to collect the information on this Form from applicants for investment adviser registration. The information is used for regulatory purposes, including deciding whether to grant registration. The SEC maintains files of the information on this form and makes it publicly available. Only the Social Security Number, which aids identifying the applicant, is voluntary. The SEC may return as unacceptable Forms that do not include all other information. By accepting this Form, however, the SEC does not make a finding that it has been filled out or submitted correctly. Intentional misstatements or omissions constitute Federal criminal violations under 18 USC 1001 and 15 USC 80b-17.

8. **Filings in Jurisdictions** — Consult the requirements of each jurisdiction in which you are filing to determine its requirements for, among other things:

   - filings
   - updates
   - financial statements
   - bonding
   - examinations and qualifications
   - photographs and fingerprints
   - limitations on advisory fees

   Information on a jurisdiction's requirements is available from its Securities Administrator. For the address and telephone number of the Securities Administrator in a jurisdiction, contact the North American Securities Administrators Association, Inc., 2930 S.W. Wanamaker Drive, Suite 5, Topeka, Kansas 66614, (913) 273-2600.

FORM ADV
Part I - Page 1

Uniform Application for Investment Adviser Registration

OMB APPROVAL
OMB No.: 3235-0049
Expires: June 30, 1988

This filing is an: ☐ Initial Application
or an: ☐ Amendment

If this filing is an Amendment:
- Give the Applicant's SEC File Number 801-_____
- Is Applicant now active in business as an Investment Adviser? Yes ☐ No ☐

WARNING: Failure to complete this Form accurately and keep it current subjects applicant to administrative, civil and criminal penalties.

1. A. Applicant's full name (If sole proprietor, state last, first and middle name):

B. Name under which business is conducted, if different:

C. If business name is being amended, give previous name:

2. A. Principal place of business: (Number and Street — Do not use P.O. Box Number) (City) (State) (Zip Code)

B. Hours business is conducted at this location:
from to

C. Telephone Number at this location: (Area Code) (Telephone Number)

D. Mailing address, if different from address given in 2A: (Number and Street or P.O. Box Number) (City) (State) (Zip Code)

E. Is the address in Item 2A or 2D being amended in this filing? Yes ☐ No ☐

F. On Schedule E give the addresses and telephone numbers of all offices at which applicant's investment advisory business is conducted, other than the one given in Item 2A.

3. A. If books and records required by Section 204 of the Investment Advisers Act of 1940 are kept somewhere other than at the principal place of business given in Item 2A, give the following information (if kept in more than one place, give additional names, addresses and hours of business on Schedule E):
Name and address of entity where books and records are kept:

(Number and Street) (City) (State) (Zip Code)

B. Hours business is conducted at this location:
from to

C. Telephone Number at this location: (Area Code) (Telephone Number)

EXECUTION

For the purpose of complying with the laws of the State(s) I have marked in Item 7 relating to the giving of investment advice, I hereby certify that the applicant is in compliance with applicable state surety bonding requirements and irrevocably appoint the administrator of each of those State(s), or such other person designated by law, and the successors in such office, my attorney in said State(s) upon whom may be served any notice, process or pleading in any action or proceeding against me arising out of or in connection with the offer or sale of securities or commodities, or out of the violation or alleged violation of the laws of those State(s) and I do hereby consent that any such action or proceeding against me may be commenced in any court of competent jurisdiction and proper venue within said State(s) by service of process upon said appointee with the same effect as if I were a resident in said State(s) and had lawfully been served with process in said State(s).

The undersigned, being first duly sworn, deposes and says that he has executed this Form on behalf of, and with the authority of, said applicant. The undersigned and applicant represent that the information and statements contained herein, including exhibits attached hereto and other information filed herewith, all of which are made a part hereof, are current, true and complete. The undersigned and applicant further represent that to the extent any information previously submitted is not amended, such information is currently accurate and complete.

Date:	Name of Applicant:	By (Signature):
Typed Name and Title:		
Subscribed and sworn before me this _____ day of _____ 19____		
By:		
My commission expires	County of	State of

Answer all items.

FORM ADV
Part I - Page 2

Applicant:	SEC File Number: 801-	Date:

4. A. Persons to contact for further information about this Form: (Name) (Title)

B. Mailing Address (Number and Street, City, State, Zip Code): | Area Code and Telephone Number: ( )

5. A. Applicant consents that notice of any proceeding before the Securities and Exchange Commission or a jurisdiction in connection with its investment adviser registration may be given by registered or certified mail or confirmed telegram to: (Last Name) (First Name) (Middle Name)

B. (Number and Street) (City) (State) (Zip Code) | 6. Applicant's fiscal year ends: (Month) (Day)

7. In the box below, give status of applicant's investment adviser registration by indicating:
"1" for pending
"2" for registered
"3" for withdrawn before registration within the last 10 years
"4" for previously registered within the last 10 years

Securities and Exchange Commission ____

AL ___ AK ___ AZ ___ AR ___ CA ___ CO ___ CT ___ DE ___ DC ___ FL ___ GA ___ HI ___ ID ___
IL ___ IN ___ IA ___ KS ___ KY ___ LA ___ ME ___ MD ___ MA ___ MI ___ MN ___ MS ___ MO ___
MT ___ NE ___ NV ___ NH ___ NJ ___ NM ___ NY ___ NC ___ ND ___ OH ___ OK ___ OR ___ PA ___
RI ___ SC ___ SD ___ TN ___ TX ___ UT ___ VT ___ VA ___ WA ___ WV ___ WI ___ WY ___ Puerto Rico ___
Other (Specify): _____

8. Applicant is a (check box that applies and complete those items):

A. ☐ CORPORATION - Complete Schedule A.	(1) Date of incorporation (Month, Day, Year):	(2) Jurisdiction where incorporated:	
B. ☐ PARTNERSHIP - Complete Schedule B.	(1) Date of establishment (Month, Day, Year):	(2) Current legal address (Number, Street, City, State, Zip Code):	
C. ☐ SOLE PROPRIETORSHIP	(1) Date business began (Month, Day, Year):	(2) Current residence address of proprietor: (Number, Street, City, State, Zip Code)	(3) Social Security No.
D. ☐ Other - Specify _____ Complete Schedule C	(1) Date of establishment (Month, Day, Year):	(2) Current legal address (Number, Street, City, State, Zip Code):	

9. Is the applicant taking over the business of a registered investment adviser? (If yes, describe the transfer on Schedule E, including the transfer date, and predecessor's full name, IRS employer number and SEC file number) ..... Yes ☐ No ☐

10. A. Does any person not named in Item 1A or Schedules A, B, or C, through agreement or otherwise, control the management or policies of applicant? ..... Yes ☐ No ☐

(If yes, state on Schedule E the exact name of each person and describe the basis for the person's control.)

B. Is the applicant financed by a person not named in Items 1A or Schedule A, B, or C other than by: (1) a public offering under the Securities Act of 1933; (2) credit given in the ordinary course of business by banks, suppliers or others; or (3) a satisfactory subordination agreement under Securities Exchange Act of 1934 Rule 15c3-1 (17 CFR 240.15c3-1)? ..... Yes ☐ No ☐

(If yes, state on Schedule E the exact name of each person and describe the arrangement through which financing is made available, including the amount.)

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV
Part I - Page 3

Applicant:	SEC File Number: 801-	Date:

11. Disciplinary questions. Definitions:

- Advisory affiliate — A person named in Items 1A, 10A or Schedules A, B or C; or an individual or firm that directly or indirectly controls or is controlled by the applicant, including any current employee except one performing only clerical, administrative, support or similar functions.
- Investment or investment-related — Pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, investment company, investment adviser, futures sponsor, bank or savings and loan association).
- Involved — Doing an act or aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act.

A. In the past ten years has the applicant or an advisory affiliate been convicted of or pleaded guilty or nolo contendre ("no contest") to:

(1) a felony or misdemeanor involving:

- investment or an investment-related business
- fraud, false statements, or omissions
- wrongful taking of property or
- bribery, forgery, counterfeiting, or extortion? ..... Yes ☐ No ☐

(2) any other felony? ..... Yes ☐ No ☐

B. Has any court:

(1) in the past ten years, enjoined the applicant or an advisory affiliate in connection with any investment-related activity? ..... Yes ☐ No ☐

(2) ever found that the applicant or an advisory affiliate was involved in a violation of investment-related statutes or regulations? ..... Yes ☐ No ☐

C. Has the U.S. Securities and Exchange Commission or the Commodity Futures Trading Commission ever:

(1) found the applicant or an advisory affiliate to have made a false statement or omission? ..... Yes ☐ No ☐

(2) found the applicant or an advisory affiliate to have been involved in a violation of its regulations or statutes? Yes ☐ No ☐

(3) found the applicant or an advisory affiliate to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted? ..... Yes ☐ No ☐

(4) entered an order denying, suspending or revoking the applicant's or an advisory affiliate's registration or otherwise disciplined it by restricting its activities? ..... Yes ☐ No ☐

D. Has any other federal regulatory agency or any state regulatory agency:

(1) ever found the applicant or an advisory affiliate to have made a false statement or omission or been dishonest, unfair, or unethical? ..... Yes ☐ No ☐

(2) ever found the applicant or an advisory affiliate to have been involved in a violation of investment regulations or statutes? ..... Yes ☐ No ☐

(3) ever found the applicant or an advisory affiliate to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted? ..... Yes ☐ No ☐

(4) in the past ten years, entered an order against the applicant or an advisory affiliate in connection with an investment-related activity? ..... Yes ☐ No ☐

(5) ever denied, suspended, or revoked the applicant's or an advisory affiliate's registration or license, prevented it from associating with an investment-related business, or otherwise disciplined it by restricting its activities? Yes ☐ No ☐

(6) ever revoked or suspended the applicant's or an advisory affiliate's license as an attorney or accountant? .. Yes ☐ No ☐

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV Part I - Page 4	Applicant:	SEC File Number: 801-	Date:

E. Has any self-regulatory organization or commodities exchange ever:

		Yes	No
(1)	found the applicant or an advisory affiliate to have made a false statement or omission?	☐	☐
(2)	found the applicant or an advisory affiliate to have been involved in a violation of its rules?	☐	☐
(3)	found the applicant or an advisory affiliate to have been the cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted?	☐	☐
(4)	disciplined the applicant or an advisory affiliate by expelling or suspending it from membership, by barring or suspending its association with other members, or by otherwise restricting its activities?	☐	☐

F. Has any foreign government, court, regulatory agency, or exchange ever entered an order against the applicant or an advisory affiliate related to investments or fraud? Yes ☐ No ☐

G. Is the applicant or an advisory affiliate now the subject of any proceeding that could result in a 'yes' answer to parts A-F of this item? Yes ☐ No ☐

H. Has a bonding company denied, paid out on, or revoked a bond for the applicant? Yes ☐ No ☐

I. Does the applicant have any unsatisfied judgments or liens against it? Yes ☐ No ☐

J. Has the applicant or an advisory affiliate of the applicant ever been a securities firm or an advisory affiliate of a securities firm that has been declared bankrupt, had a trustee appointed under the Securities Investor Protection Act, or had a direct payment procedure begun? Yes ☐ No ☐

K. Has the applicant, or an officer, director or person owning 10% or more of the applicant's securities failed in business, made a compromise with creditors, filed a bankruptcy petition or been declared bankrupt? Yes ☐ No ☐

If a 'yes' answer on Item 11 involves:

- an individual, complete a Schedule D for the individual
- a partnership, corporation or other organization, on Schedule E give the following details of any court or regulatory action:
  - the organization and individuals named
  - the title and date of the action
  - the court or body taking the action
  - a description of the action.

12. Individual's Education, Business and Disciplinary Background. Complete a Schedule D for each individual who is:

A. The applicant, named in Part I Item 1A

B. A control person named in Part I Item 10

C. An owner of at least 10% of a class of applicant's equity securities

D. An officer, director, partner, or individual with similar status of applicant, described in Schedule A Item 2a, Schedule B Item 2, or Schedule C Item 2

E. A member of the applicant's investment committee that determines general investment advice to be given to clients

F. If applicant has no investment committee, an individual who determines general investment advice (if more than five, complete for their supervisors only)

G. An individual giving investment advice on behalf of the applicant in the jurisdiction in which this application is filed

H. An individual reporting a 'yes' answer to the disciplinary question, Part I Item 11

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV Part I - Page 5	Applicant:	SEC File Number: 801-	Date:

13. Does applicant have custody (see definition in instructions) of any advisory client:

A. funds ..... Yes ☐ No ☐

B. securities ..... Yes ☐ No ☐

C. If either answer is yes, the value of those funds and securities at the end of applicant's last fiscal year was:

(1) ☐ under $100,000

(2) ☐ $100,000 to $1,000,000

(3) ☐ $1,000,0001 to $5,000,000

(4) ☐ Over $5,000,000

14. Do any of applicant's related persons have custody (see definition in instructions) of any advisory client:

A. funds ..... Yes ☐ No ☐

B. securities ..... Yes ☐ No ☐

If either is yes:

C. is that person a registered broker-dealer qualified to take custody under Section 15 of the Securities Exchange Act of 1934? ..... Yes ☐ No ☐

D. the value of those funds and securities at the end of applicant's last fiscal year was:

(1) ☐ under $100,000

(2) ☐ $100,000 to $1,000,000

(3) ☐ $1,000,001 to $5,000,000

(4) ☐ Over $5,000,000

15. Does applicant require prepayment of fees of more than $500 per client and more than 6 months in advance? ..... Yes ☐ No ☐

16. With a few exceptions, the "brochure rule" (Advisers Act Rule 204-3) requires that clients must be given information about the investment adviser. Will applicant be giving clients:

A. Part II of this Form ADV? ..... Yes ☐ No ☐

B. Another document that includes at least the information contained in Form ADV Part II? ..... Yes ☐ No ☐

17. A. The number of employees of applicant who perform investment advisory functions (including research, but excluding unrelated functions such as accounting) is: (check only one box)

(1) ☐ 1 person, part time

(2) ☐ 1 person primarily involved in providing investment advisory services

(3) ☐ 2-9 persons

(4) ☐ 10 or more persons

B. The number of clients to whom applicant provided advisory services during the last fiscal year was:

(1) ☐ 14 or fewer

(2) ☐ 15 to 50

(3) ☐ 51 to 100

(4) ☐ 101 to 500

(5) ☐ over 500

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV
Part I - Page 6

Applicant:	SEC File Number: 801-	Date:

18. Does applicant manage client securities portfolios on a discretionary basis? ..... Yes ☐ No ☐

If yes, at the end of applicant's last fiscal year these accounts:

A. numbered _____.

B. totaled in aggregate market value, rounded to nearest thousand ..... $_____000.00

19. Does applicant manage or supervise client securities portfolios on a non-discretionary basis? ..... Yes ☐ No ☐

If yes, at the end of applicant's last fiscal year these accounts:

A. numbered _____.

B. totaled in aggregate market value, rounded to nearest thousand ..... $_____000.00

20. Does applicant hold itself out as providing financial planning or some similarly termed services to clients? ..... Yes ☐ No ☐

If yes, during the last fiscal year applicant provided financial planning services to clients:

A. who numbered:

(1) ☐ 14 or fewer

(2) ☐ 15 to 50

(3) ☐ 51 to 100

(4) ☐ 101 to 500

(5) ☐ over 500

B. whose investments in financial products based on those services totaled:

(1) ☐ under $100,000

(2) ☐ $100,000 to $1,000,000

(3) ☐ $1,000,001 to $5,000,000

(4) ☐ over $5,000,000

21. Did applicant recommend securities to clients during its last fiscal year in which the applicant acted (itself or through a related person) as an underwriter, general or managing partner, or offeree representative, or had any ownership or sales interest (other than the receipt of normal and customary sales commissions as a broker or brokers representative)? ... Yes ☐ No ☐

If yes, the approximate value of securities so recommended during its last fiscal year is:

A. ☐ Under $50,000

B. ☐ $50,000 to $250,000

C. ☐ $250,001 to $1,000,000

D. ☐ over $1,000,000

22. Attach to this Form any financial statements required by the jurisdiction in which applicant is filing, other than the balance sheet required by Part II Item 14.

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV
Part II - Page 1

Uniform Application for Investment Adviser Registration

OMB APPROVAL
OMB No.: 3235-0049
Expires: June 30, 1988

Name of Investment Adviser:						
Address:	(Number and Street)	(City)	State)	(Zip Code)	Area Code: ( )	Telephone Number:

This part of Form ADV gives information about the investment adviser and its business for the use of clients. The information has not been approved or verified by any governmental authority.

Table of Contents

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	Balance Sheet, if required	Schedule G

(Schedules A, B, C, D, and E are included with Part I of this Form, for the use of regulatory bodies, and are not distributed to clients.)

FORM ADV Part II- Page 2	Applicant:	SEC File Number: 801-	Date:

Definitions for Part II

Related person — Any officer, director or partner of applicant or any person directly or indirectly controlling, controlled by, or under common control with the applicant, including any non-clerical, non-ministerial employee.

Investment Supervisory Services — Giving continuous investment advice to a client (or making investments for the client) based on the individual needs of the client. Individual needs include, for example, the nature of other client assets and the client's personal and family obligations.

1. A. **Advisory Services and Fees.** (check the applicable boxes)

Applicant:

For each type of service provided, state the approximate % of total advisory billings from that service. (See instruction below.)

- ☐ (1) Provides investment supervisory services ..... _____%
- ☐ (2) Manages investment advisory accounts not involving investment supervisory services ..... _____%
- ☐ (3) Furnishes investment advice through consultations not included in either service described above ..... _____%
- ☐ (4) Issues periodicals about securities by subscription ..... _____%
- ☐ (5) Issues special reports about securities not included in any service described above ..... _____%
- ☐ (6) Issues, not as part of any service described above, any charts, graphs, formulas, or other devices which clients may use to evaluate securities ..... _____%
- ☐ (7) On more than an occasional basis, furnishes advice to clients on matters not involving securities ..... _____%
- ☐ (8) Provides a timing service ..... _____%
- ☐ (9) Furnishes advice about securities in any manner not described above ..... _____%

(Percentages should be based on applicant's last fiscal year. If applicant has not completed its first fiscal year, provide estimates of advisory billings for that year and state that the percentages are estimates.)

B. Does applicant call any of the services it checked above financial planning or some similar term? ..... Yes ☐ No ☐

C. Applicant offers investment advisory services for: (check all that apply)

- ☐ (1) A percentage of assets under management
- ☐ (2) Hourly charges
- ☐ (3) Fixed fees (not including subscription fees)
- ☐ (4) Subscription fees
- ☐ (5) Commissions
- ☐ (6) Other

D. For each checked box in A above, describe on Schedule F:

- the services provided, including the name of any publication or report issued by the adviser on a subscription basis or for a fee
- applicant's basic fee schedule, how fees are charged and whether its fees are negotiable
- when compensation is payable, and if compensation is payable before service is provided, how a client may get a refund or may terminate an investment advisory contract before its expiration date

2. **Types of Clients** — Applicant generally provides investment advice to: (check those that apply)

- ☐ A. Individuals
- ☐ B. Banks or thrift institutions
- ☐ C. Investment companies
- ☐ D. Pension and profit sharing plans
- ☐ E. Trusts, estates, or charitable organizations
- ☐ F. Corporations or business entities other than those listed above
- ☐ G. Other (describe on Schedule F)

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV Part II- Page 3	Applicant:	SEC File Number: 801-	Date:

3. **Types of Investments.** Applicant offers advice on the following: (check those that apply)

- ☐ A. Equity Securities
  - ☐ (1) exchange-listed securities
  - ☐ (2) securities traded over-the-counter
  - ☐ (3) foreign issuers
- ☐ B. Warrants
- ☐ C. Corporate debt securities (other than commercial paper)
- ☐ D. Commercial paper
- ☐ E. Certificates of deposit
- ☐ F. Municipal securities
- ☐ G. Investment company securities:
  - ☐ (1) variable life insurance
  - ☐ (2) variable annuities
  - ☐ (3) mutual fund shares
- ☐ H. United States government securities
- ☐ I. Options contracts on:
  - ☐ (1) securities
  - ☐ (2) commodities
- ☐ J. Futures contracts on:
  - ☐ (1) tangibles
  - ☐ (2) intangibles
- ☐ K. Interests in partnerships investing in:
  - ☐ (1) real estate
  - ☐ (2) oil and gas interests
  - ☐ (3) other (explain on Schedule F)
- ☐ L. Other (explain on Schedule F)

4. **Methods of Analysis, Sources of Information, and Investment Strategies.**

A. Applicant's security analysis methods include: (check those that apply)

- (1) ☐ Charting
- (2) ☐ Fundamental
- (3) ☐ Technical
- (4) ☐ Cyclical
- (5) ☐ Other (explain on Schedule F)

B. The main sources of information applicant uses include: (check those that apply)

- (1) ☐ Financial newspapers and magazines
- (2) ☐ Inspections of corporate activities
- (3) ☐ Research materials prepared by others
- (4) ☐ Corporate rating services
- (5) ☐ Timing services
- (6) ☐ Annual reports, prospectuses, filings with the Securities and Exchange Commission
- (7) ☐ Company press releases
- (8) ☐ Other (explain on Schedule F)

C. The investment strategies used to implement any investment advice given to clients include: (check those that apply)

- (1) ☐ Long term purchases (securities held at least a year)
- (2) ☐ Short term purchases (securities sold within a year)
- (3) ☐ Trading (securities sold within 30 days)
- (4) ☐ Short sales
- (5) ☐ Margin transactions
- (6) ☐ Option writing, including covered options, uncovered options or spreading strategies
- (7) ☐ Other (explain on Schedule F)

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV Part II - Page 4	Applicant:	SEC File Number: 801-	Date:

5. **Education and Business Standards.**

Are there any general standards of education or business experience that applicant requires of those involved in determining or giving investment advice to clients? ☐ Yes ☐ No

(If yes, describe these standards on Schedule F.)

6. **Education and Business Background.**

For:

- each member of the investment committee or group that determines general investment advice to be given to clients, or
- if the applicant has no investment committee or group, each individual who determines general investment advice given to clients (if more than five, respond only for their supervisors)
- each principal executive officer of applicant or each person with similar status or performing similar functions.

On Schedule F, give the:

- name
- year of birth
- formal education after high school
- business background for the preceding five years

7. **Other Business Activities.** (check those that apply)

☐ A. Applicant is actively engaged in a business other than giving investment advice.

☐ B. Applicant sells products or services other than investment advice to clients.

☐ C. The principal business of applicant or its principal executive officers involves something other than providing investment advice.

(For each checked box describe the other activities, including the time spent on them, on Schedule F.)

8. **Other Financial Industry Activities or Affiliations.** (check those that apply)

☐ A. Applicant is registered (or has an application pending) as a securities broker-dealer.

☐ B. Applicant is registered (or has an application pending) as a futures commission merchant, commodity pool operator or commodity trading adviser.

C. Applicant has arrangements that are material to its advisory business or its clients with a related person who is a:

☐ (1) broker-dealer
☐ (2) investment company
☐ (3) other investment adviser
☐ (4) financial planning firm
☐ (5) commodity pool operator, commodity trading adviser or futures commission merchant
☐ (6) banking or thrift institution
☐ (7) accounting firm
☐ (8) law firm
☐ (9) insurance company or agency
☐ (10) pension consultant
☐ (11) real estate broker or dealer
☐ (12) entity that creates or packages limited partnerships

(For each checked box in C, on Schedule F identify the related person and describe the relationship and the arrangements.)

D. Is applicant or a related person a general partner in any partnership in which clients are solicited to invest? ☐ Yes ☐ No

(If yes, describe on Schedule F the partnerships and what they invest in.)

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1).

FORM ADV Part II - Page 5	Applicant:	SEC File Number: 801-	Date:

9. Participation or Interest in Client Transactions.

Applicant or a related person: (check those that apply)

☐ A. As principal, buys securities for itself from or sells securities it owns to any client.

☐ B. As broker or agent effects securities transactions for compensation for any client.

☐ C. As broker or agent for any person other than a client effects transactions in which client securities are sold to or bought from a brokerage customer.

☐ D. Recommends to clients that they buy or sell securities or investment products in which the applicant or a related person has some financial interest.

☐ E. Buys or sells for itself securities that it also recommends to clients.

(For each box checked, describe on Schedule F when the applicant or a related person engages in these transactions and what restrictions, internal procedures, or disclosures are used for conflicts of interest in those transactions.)

10. Conditions for Managing Accounts. Does the applicant provide investment supervisory services, manage investment advisory accounts or hold itself out as providing financial planning or some similarly termed services *and* impose a minimum dollar value of assets or other conditions for starting or maintaining an account? ..... Yes ☐ No ☐

(If yes, describe on Schedule F.)

11. Review of Accounts. If applicant provides investment supervisory services, manages investment advisory accounts, or holds itself out as providing financial planning or some similarly termed services:

A. Describe below the reviews and reviewers of the accounts. For reviews, include their frequency, different levels, and triggering factors. For reviewers, include the number of reviewers, their titles and functions, instructions they receive from applicant on performing reviews, and number of accounts assigned each.

B. Describe below the nature and frequency of regular reports to clients on their accounts.

Answer all items. Complete amended pages in full, check amended items and file with amendment page (page 1).

FORM ADV Part II - Page 6	Applicant:	SEC File Number: 801-	Date:

12. **Investment or Brokerage Discretion.**

A. Does applicant or any related person have authority to determine, without obtaining specific client consent, the:

(1) securities to be bought or sold? ☐ Yes ☐ No

(2) amount of the securities to be bought or sold? ☐ Yes ☐ No

(3) broker or dealer to be used? ☐ Yes ☐ No

(4) commission rates paid? ☐ Yes ☐ No

B. Does applicant or a related person suggest brokers to clients? ☐ Yes ☐ No

For each yes answer to A describe on Schedule F any limitations on the authority. For each yes to A(3), A(4) or B, describe on Schedule F the factors considered in selecting brokers and determining the reasonableness of their commissions. If the value of products, research and services given to the applicant or a related person is a factor, describe:

- the products, research and services
- whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services
- whether research is used to service all of applicant's accounts or just those accounts paying for it; and
- any procedures the applicant used during the last fiscal year to direct client transactions to a particular broker in return for products and research services received.

13. **Additional Compensation.**

Does the applicant or a related person have any arrangements, oral or in writing, where it:

A. is paid cash by or receives some economic benefit (including commissions, equipment or non-research services) from a non-client in connection with giving advice to clients? ☐ Yes ☐ No

B. directly or indirectly compensates any person for client referrals? ☐ Yes ☐ No

(For each yes, describe the arrangements on Schedule F.

14. **Balance Sheet.** Applicant must provide a balance sheet for the most recent fiscal year on Schedule G if applicant:

- has custody of client funds or securities; or
- requires prepayment of more than $500 in fees per client and 6 or more months in advance

Has applicant provided a Schedule G balance sheet? ☐ Yes ☐ No

Answer all items. Complete amended pages in full, circle amended items and file with amendment page (page 1).

Schedule A of Form ADV FOR CORPORATIONS	Applicant:	SEC File Number: 801-	Date:	Official Use

(Answers for Form ADV Part 1 Item 8.)

1. This Schedule requests information on the owners and executive officers of the applicant.

2. Please complete for:

   (a) each Chief Executive Officer, Chief Financial Officer, Chief Operations Officer, Chief Legal Officer, Chief Compliance Officer, director, and individuals with similar status or functions, and

   (b) every person who is directly, or indirectly through intermediaries, the beneficial owner of 5% or more of any class of equity security of the applicant.

3. If a person covered by 2(b) above owns applicant indirectly through intermediaries, list all intermediaries and below them, if they are not subject to Sections 12 or 15(d) of the Securities Exchange Act of 1934 but are:

   (a) corporations, give their shareholders who own 5% or more of a class of equity security, or

   (b) partnerships, give their general partners or any limited and special partners who have contributed 5% or more of the partnership's capital.

4. If the intermediary's shareholders or partners listed under 3 above are not individuals, continue up the chain of ownership listing their 5% shareholders, general partners, and 5% limited or special partners until individuals are listed.

5. Ownership codes are: NA - 0 up to 5% A - 5% up to 10% B - 10% up to 25% C - 25% up to 50% D - 50% up to 75% E - 75% up to 100%

6. Asterisk (*) names reporting a change in title, status, stock ownership or partnership interest or control. Double asterisk (**) names new on this filing.

7. Check "Control Person" column if person has "control" as defined in the instructions to this Form.

FULL NAME Last	First	Middle	Beginning Date Month	Year	Title or Status	Ownership Code	Control Person	CRD No., or, if none Social Security Number	OFFICIAL USE ONLY

List below names reported on the most recent previous filing under this item that are being DELETED:

FULL NAME Last	First	Middle	Ending Date Month	Year	CRD. No., or, if none Social Security Number

Complete amended pages in full, circle amended items and file with execution page (page 1).

Schedule B of Form ADV FOR PARTNERSHIPS	Applicant:	SEC File Number: 801-	Date:	Official Use

(Answers for Form ADV Part I Item 8.)

1. This Schedule requests information on the owners and partners of the applicant.

2. Please complete for all general partners and with respect to limited and special partners all those who have contributed directly or indirectly through intermediaries, 5% or more of the partnership's capital.

3. If a person owns applicant indirectly through intermediaries, list all intermediaries and below them, if they are not subject to Sections 12 or 15(d) of the Securities Exchange Act of 1934 but are:

   (a) corporations, give their shareholders who own 5% or more of a class of equity security, or

   (b) partnerships, give their general partners or any limited and special partners who have contributed 5% or more of the partnership's capital.

4. If the intermediary's shareholders or partners listed under 3 above are not individuals, continue up the chain of ownership listing their 5% shareholders, general partners, and 5% limited or special partners until individuals are listed.

5. Ownership codes are: NA - 0 up to 5% A - 5% up to 10% B - 10% up to 25% C - 25% up to 50% D - 50% up to 75% E - 75% up to 100%

6. Asterisk (*) names reporting a change in title, status, stock ownership or partnership interest or control. Double asterisk (**) names new on this filing.

7. Check "Control Person" column if person has "control" as defined in the instructions to this Form.

FULL NAME Last	First	Middle	Beginning Date Month	Year	Title or Status	Ownership Code	Control Person	CRD No., or, if none Social Security Number	OFFICIAL USE ONLY

List below names reported on the most recent previous filing under this item that are being DELETED:

FULL NAME Last	First	Middle	Ending Date Month	Year	CRD No., or, if none Social Security Number

Complete amended pages in full, circle amended items and file with execution page (page 1)

Schedule C of Form ADV for OTHER THAN Partnerships and Corporations	Applicant:	SEC File Number: 801-	Date:	Official Use

(Answers for Form ADV Part I Item 8.)

1. This Schedule requests information on the owners and executive officers of the applicant.
2. Please complete for each person, including trustees, who participates in directing or managing the applicant.
3. Give each listed person's title or status, and describe the person's authority and beneficial interest in applicant. Sole proprietors must be identified in the "Title or Status" column.
4. Astrisk (*) names reporting a change in title, status, stock ownership or partnership interest. Double asterisk (**) names new on this filing.

FULL NAME Last	First	Middle	RELATIONSHIP Beginning Date Month	Year	Title or Status	CRD No., or, if none Social Security Number	Description of Authority and Beneficial Interest

List below names reported on the most recent previous filing under this item that are being DELETED:

FULL NAME Last	First	Middle	Ending Date Month	Year	CRD No., or, if none Social Security Number

Complete amended pages in full, circle amended items and file with execution page (page 1).

Schedule D of Form ADV Page 1	Applicant:	SEC File Number: 801-	Date:

(Answers for Form ADV Part I Items 11 and 12.)

This Schedule is submitted for an individual who is: (Check all boxes that apply)

☐ A. the applicant, named in Part I Item 1A

☐ B. a control person, named in Part I Item 10A

☐ C. an owner of at least 10% of a class of applicant's equity securities

☐ D. an officer or director, partner, or individual with similar status of applicant, described in Schedule A Item 2a, Schedule B Item 2, or Schedule C Item 2

☐ E. a member of the applicant's investment committee that determines general investment advice to be given to clients

☐ F. if applicant has no investment committee, an individual who determines general client advice (if more than five, complete for their supervisors only)

☐ G. an individual giving investment advice on behalf of the applicant in the jurisdictions checked below:

AL ___ AK ___ AZ ___ AR ___ CA ___ CO ___ CT ___ DE ___ DC ___ FL ___ GA ___ HI ___ ID ___
IL ___ IN ___ IA ___ KS ___ KY ___ LA ___ ME ___ MD ___ MA ___ MI ___ MN ___ MS ___ MO ___
MT ___ NE ___ NV ___ NH ___ NJ ___ NM ___ NY ___ NC ___ ND ___ OH ___ OK ___ OR ___ PA ___
RI ___ SC ___ SD ___ TN ___ TX ___ UT ___ VT ___ VA ___ WA ___ WV___ WI ___ WY___ Puerto Rico ___
Other: _____
(Specify)

☐ H. involved in any yes answer to the disciplinary question, Part I Item 11.

Complete amended pages in full, circle amended items and file with execution page (page 1).

Schedule D of Form ADV Page 2

Applicant:	SEC File Number: 801-	Date:

(Answers for Form ADV Part I Items 11 and 12.)

1. Applicant investment adviser: (see Part I Item 1A) — IRS Empl. Ident. No.:

2. Individual's full name for whom this Schedule is being completed: | Social Security Number: | CRD No., if any: | IRS Empl. Ident. No.:

3. (a) Residence of individual: (Number and Street) (City) (State) (Zip Code)

(b) Birth Date: | (c) City: | (d) State or Province: | (e) Country:

4. NAMES USED. List all names other than the one given in Item 2 above that the individual has used, including maiden names.
(Last) (First) (Middle)

5. EDUCATION. Start with last high school attended. If no degree received, state "none."

School: (Name, City and State)	Years Attended	Year Graduated	For College and above: Degree	Major

6. BUSINESS BACKGROUND. Provide complete consecutive statement of all employment for the past ten years, beginning with the most recent position first.

Name of Firm and Address	Kind of Business	Exact Nature of Connection or Employment	Beginning Date: Month	Year	Ending Date: Month	Year

7. EXAMINATIONS/PROFESSIONAL DESIGNATIONS. List all jurisdiction, self-regulatory organization, and professional examinations and designations. Give examination or designation name (include any examination's title and number), body giving it, and date taken or conferred. If examination was waived, give details.

8. PROCEEDINGS. For each 'yes' answer to Part I Item 11 involving the individual, give the following details of any court or regulatory action:

- the adviser and individuals named,
- the title and date of the action,
- the court or body taking the action, and
- a description of the action.

Complete amended pages in full, circle amended items and file with execution page (page 1).

Schedule E of Form ADV
Continuation Sheet for Form ADV Part I

Applicant:	SEC File Number: 801-	Date:

(Do not use this Schedule as a continuation sheet for Form ADV Part II or any other schedules.)

1. Full name of applicant exactly as stated in Item 1A of Part I of Form ADV:	IRS Empl. Ident. No.:

Item of Form (identify)	Answer

Complete amended pages in full, circle amended items and file with execution page (page 1).

Schedule F of Form ADV Continuation Sheet for Form ADV Part II

Applicant:	SEC File Number: 801-	Date:

(Do not use this Schedule as a continuation sheet for Form ADV Part I or any other schedules.)

1. Full name of applicant exactly as stated in Item 1A of Part I of Form ADV:	IRS Empl. Identif. No.:

Item of Form (identify)	Answer

Complete amended pages in full, circle amended items and file with execution page (page 1).

Schedule G of Form ADV Balance Sheet	Applicant:	SEC File Number: 801-	Date:

(Answers in Response to Item 4 of Form ADV-S, or Form ADV Part II Item 14.)

1. Full name of applicant exactly as stated in Item 1A of Part I of Form ADV:	IRS Empl. Identn. No.:

Instructions

1. The balance sheet must be:

   A. Prepared in accordance with generally accepted accounting principles

   B. Audited by an independent public accountant

   C. Accompanied by a note stating the principles used to prepare it, the basis of included securities, and any other explanations required for clarity.

2. Securities included at cost should show their market or fair value parenthetically.

3. Qualifications and any accompanying independent accountant's report must conform to Article 2 of Regulation S-X (17 CFR 210.2-01 et seq.).

4. Sole proprietor investment advisers:

   A. Must show investment advisory business assets and liabilities separate from other business and personal assets and liabilities

   B. May aggregate other business and personal assets and liabilities unless there is an asset deficiency in the total financial position.

Complete amended pages in full, circle amended items and file with execution page (page 1).

Senator DODD. Thank you both very much for being here this morning. You may have heard—I presume you did—I think you were in the room, Mr. Chairman, that I asked Ms. Roper from the CFA about the numbers and we have this morning the reports from the North American Securities Administrators some numbers as well.

I wonder if you might—maybe I ought to address this to Ms. McGrath, whichever way is the most comfortable——

Mr. RUDER. I'll take a crack at it and then she can add to it.

Senator DODD. Just give us some idea, talking about the numbers overall and the incidence of abuse and fraud as it relates to that.

DIFFERENCE IN NUMBERS

Mr. RUDER. As I prepared for this hearing, I was concerned, as are you, by the difference in numbers that we're reporting and the numbers that are reported in the other study.

My analysis goes something like this. First of all, there's a difference in numbers because we report investment advisers, and those are the financial planners that are making recommendations regarding securities. So if a financial planner is not making recommendations regarding securities, we won't pick that person up.

Second, as to the release to which Mrs. McGrath referred, our October 8, 1987 release, defining investment adviser in the financial planning area, I think probably when it becomes fully understood by those in the financial planning area, the result will be more registrations with us by investment advisers. So I expect that there are some people out there who are actually investment advisers who have not registered with us.

Third, there are, as I've indicated, a great number of exclusions. I think the most important one is the financial planner who gives advice only intrastate. That is, to clients located in one State. We would not regulate them.

Senator DODD. Does that apply as well if you're only giving advice not only in that State but if they're making investments with that clients money that go out of State—does that not trigger an interstate activity?

Mr. RUDER. I think the statute says where the client is located.

Mrs. MCGRATH. If they give advice about exchange listed securities, the exclusion is not available. If they make investments on behalf of the client any place, they probably get picked up by SEC broker-dealer regulation.

Mr. RUDER. Finally, I really can't reconcile the large differences. One other thing Ms. McGrath talked about is that we register the firms, so if the firm has several thousands of employees we would not pick up the employees but only the firm, but that doesn't really reconcile itself with the yellow book analysis that's been made nor with our average figures. We find there's an average of about three people employed by each of the registrants.

So I'm not entirely able to make a full reconciliation of the number of 250,000 to 400,000 except on some assumptions based upon those numbers.

Senator DODD. And your assumptions deal, as you just described, with a narrower group, so your numbers—it doesn't surprise you that your numbers are lower?

Mr. RUDER. The fact that they are lower does not surprise me at all. I must say the 60,000 California figure was a stunning number to me and I heard the colloquy before and I would be inclined to multiply it by more than four to try to get a universe if that number was correct.

Senator DODD. The CFA number may be low?

Mr. RUDER. Well, if 60,000 is right, I suspect 250,000 is low.

Senator DODD. Thanks very much. In your testimony you cite the brochure rule that requires registered investment advisers to provide clients with information about the adviser's education and business background. Would the brochure rule require disclosure of a person being thrown out of an institute of financial planners of certified planners? You may have heard—I don't know if you heard our first witness.

BROCHURE RULE

Mr. RUDER. I don't know the answer to that. I would presume not.

Mrs. MCGRATH. We don't spell that out as a type of disciplinary action that must be disclosed to clients. It wasn't on the list.

Senator DODD. Should it be?

Mrs. MCGRATH. Well, I'm thinking about that. If they asked us for interpretative advice, probably we would say yes, because this requirement for disclosure comes under the general antifraud provision and an interpretation of fiduciary duty and I would say that as a fiduciary—interpreting a fiduciary law like the Advisers Act, we ought to say that a person needs to tell a client if they've been thrown out of the principal trade association for bad behavior. So we'll figure out a release to put that in.

Mr. RUDER. In appendix E of our report we have included form ADV, which is a very extensive report with lots of schedules in it. It's some 10 pages long and as I understand the brochure rule, you may either send your client a form ADV or you may prepare a similar disclosure document which is not that form. I guess the more sophisticated ones prepare different brochures.

Mrs. MCGRATH. They've lots of pictures of themselves talking to clients.

Senator DODD. I don't know anybody who does that around here. [Laughter.]

Just to go back to the finance advice, except for the ones of the narrow exceptions or the few exceptions, should all people who provide financial advice, in your opinions, be required to disclose this kind of information, regardless of whether or not they give advice on just securities in your view—that kind of information?

Mr. RUDER. My view is that at some level it would be beneficial to have people who are in the business of giving financial advice make full disclosure regarding their backgrounds and to have fiduciary obligations attached to them. As I think Kathie testified, the main problem that we find is that these people are likely to sell their own products to the individual and I think that the disclosure

of their relationship with their product sources is one area that would be extremely important for the investor to receive.

Senator DODD. Do you agree with that, Mrs. McGrath?

Mrs. MCGRATH. Yes. I think people that seek financial planner services wouldn't have the assets to pay the cost of traditional money management investment counsel service, so they wind up paying what is a relatively modest fee for a plan and then for the financial planners to make any money at it, with this type of clientele, they supplement their income with commissions on selling products. There's nothing inherently wrong with that, but it's a conflict that we feel needs to be disclosed to clients and we require registered advisers to do just that and also to tell their client that the client can go down the street to another brokerage firm to buy those securities. We try to make sure that people do that when we inspect them.

Senator DODD. Probably if they're representing one company, it's one fact situation, but if they're actually going to be taking commissions from a variety of different companies as a result of selling those products, then you're raising it seems to me the requirements in that kind of an area. That would be one distinction.

What about the knowledge and background and education? Some States, I think you pointed out, Chairman Ruder, in your testimony, require the listing of background, education, experience. Should the Federal Government require similar disclosures or is that the kind of thing that just starts driving up prices?

Mrs. MCGRATH. We require disclosure of business background and education but we don't say that you have to have so much education or a degree in any particular field and we don't give adviser registrants a test to see if they know anything about what they're doing or the law.

The States parallel our disclosure requirements and in addition to that, many States have authority to, and are starting to, require a certain amount of education and the passing of a test.

Mr. RUDER. I think one distinction which might be pointed out—it relates to the SRO suggestion—is that under the Investment Advisers Act our legislative mandate is not as broad as it is under the broker-dealer provisions of the Securities Exchange Act. We do not have direct rulemaking power over conduct by investment advisers to the same extent that broker-dealers are regulated by the SRO's and the SEC together.

If there should be an SRO which had investment adviser responsibility, then presumably the SRO would have the ability to adopt rules, specific rules such as they now have in the broker-dealer field, that would put us into regulating conduct or by these financial planners or investment advisers such as suitability and reasonable basis, which are part of the broker-dealer SRO conduct rules. As I understand it, the SRO provision, if it were brought to its fullest, would require legislation.

Senator DODD. Again going back to my first question on numbers, whether you accept the numbers of the CFA or the North American Securities Administrators Association or the SEC, we've seen an explosion in the amount of people involved in the business but, more importantly I think, the tremendous increase in the

amount of money, if the estimates are accurate, in the area of $4 trillion now being managed by investment advisers and the like.

PRIVATE RIGHTS OF ACTION

Would you endorse legislation that would restore the private rights of action, given the limited resources that you folks have and others and the likelihood, despite the fact that we may try to fight harder to try to see to it that you get some more money to help in this field—obviously, I think all of us recognize it's going to be slim pickings for a while. Wouldn't it make some sense at this point to restore the private rights of action in this area rather than continue along on the basis that we are?

Mr. RUDER. Senator Dodd, my comments here are not as a spokesman for the Securities and Exchange Commission, but speaking personally, I would endorse legislation applying private right of action standards to the antifraud provisions of the Investment Advisers Act.

Senator DODD. Mrs. McGrath?

Mrs. MCGRATH. Yes, sir.

Mr. RUDER. You're sitting with one of the toughest regulators in the United States.

Senator DODD. I know that, but I just like to hear it.

Mr. RUDER. And I'm not talking about myself. I'm talking about Ms. McGrath.

Senator DODD. You may again have heard Ms. Roper of the CFA talk about increasing fees, not because you're going to discourage people from getting into business—and that was not her point—but rather to try and help bring in some needed revenues in this particular area. Would you endorse the notion of increasing fees for that purpose?

Mr. RUDER. I think that, again speaking personally, I would endorse the raising of fees, but not for the revenue raising purposes, but as a means of separating the chaff from the wheat. It may be that if the nominal fee that we charge now is raised to an $800 or $1,000 level there would be some people who would decide that it was too costly to go into business. Those people, if they were excluded, would be the ones we would want to exclude.

Regarding revenues, I can only tell you that we already raise approximately twice as much money from our fee sources than is available to us from the Federal Government for our activities so that any additional revenues would merely go into the Treasury.

Senator DODD. Well, obviously, as staff points out, earmarking is what we're talking about here, where you earmark this specifically.

Mr. RUDER. That's a possibility.

Senator DODD. I have unease about earmarkings in this particular area. Once you start it, it's a never ending process and I think it will create more problems than it will solve.

Mr. RUDER. Well, I'm not embarrassed to say that we need more resources.

Senator DODD. I know that.

Mr. RUDER. So that would be a pleasant event if it occurred.

Senator DODD. I'm not surprised to hear you say that.

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In your testimony you say the SEC can refer alleged violations to the Department of Justice for prosecutions. How often have you done that?

Ms. MCGRATH. In the adviser area, I can't give you a specific number. It's relatively small. We do better with State prosecutors and working through our colleagues, the State securities administrators, because so many of the adviser cases are small potatoes and not viewed with great favor by Federal prosecutors.

Senator DODD. This is at the state level or the federal level?

Ms. MCGRATH. At the federal level. The U.S. attorney looking at an adviser who's ripped $100,000 or so off the people in a small town isn't going to get excited when we knock on his or her door, but the local prosecutor is. We do some work with prosecutors every year to try to sell them on the notion of prosecuting white collar crime, that white collar crime cases are good cases and worth bringing.

In the advisory area, unfortunately, most of the cases are small and they're not of real interest to Federal prosecutors.

Senator DODD. Does that discourage you from sending them over or do you still send them over?

Mrs. MCGRATH. It discourages us from sending them over, but we do sort of turn then and look to the States.

Mr. RUDER. If we get a good mail fraud case—that is, if we can identify somebody who has stolen money, that's an easier referral to the Federal authorities than a securities-related case. The problem nationally is that the U.S. attorney's offices are not staffed with people who are knowledgeable in the securities field, so that when we send a securities case over to them they are not very willing to pursue it because it means they will have to put a fairly large number of staff personnel onto that case. We occasionally find that when we send a relatively major case we have to detail one or two staff attorneys to the U.S. attorney's office so that they can assist the U.S. attorney's office in the matter. But even that is a negative factor for us because we lose that attorney in terms of our own staff resources.

Senator DODD. I understand that. Well, I appreciate your being here. There may be others who will have some questions for you from the subcommittee and if they do we will submit them to you in writing. I'd like to stay in touch with you on this and your staff. As I said at the outset, I'm not sure in my own mind whether or not there's a need for legislation in this area. I don't exclude that at all. I'm not ruling that out and I wouldn't want to leave anyone with that impression either, but I'd like to get a better sense of all of this and some of the recommendations and thoughts that you might have over the next several months as to whether or not we ought to proceed or may have to proceed with legislation in this area.

Mr. RUDER. We will continue to follow this area and be available for you to respond to whatever questions or comments you want.

Senator DODD. I thank you very much. Ms. McGrath, are you going to stay around with us? I'd like you to because we've got some of the State people coming up and some of the questions involve the coordination between State and Federal.

Mrs. MCGRATH. Yes. I thought I'd move down to the end of the row, though.

Senator DODD. All right. Our third panel is James Meyer, president of North American Securities Administrators Association; Frank Wilson, executive vice president, National Association of Securities Dealers; and we're going to keep Kathryn McGrath around from the SEC. We welcome you here this morning and we'll begin with you, Mr. Meyer, in the order that I've introduced you. Again, if you have prepared statements I'm going to ask you to try and keep them down to about 5 to 7 minutes. If they run longer, obviously we'll make them a part of the record.

We will proceed with you, Mr. Meyer.

STATEMENT OF JAMES C. MEYER, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, WASHINGTON, DC

Mr. MEYER. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you today. NASAA, in connection with my written testimony, has just completed a survey of enforcement actions carried out by 30 States which reveals that over the last 2 years some 22,000 investors have suffered a staggering $400 million in investor losses as a result of fraud and abuse in the financial planning industry. The extent of the financial planner fraud and abuse which was uncovered in this survey is up dramatically from a comparable survey that the association did in 1985.

Now why is this? Well, there are two basic trends that drive up the figures.

First of all, there's been an actual increase in the level of fraud and abuse that has been committed by those self-proclaimed and registered financial planners. This is particularly true with respect to "big ticket" cases involving aggregate investor losses in excess of $30 million. In 1985 when we did our first study, I believe there was one case in excess of $20 million. Now we find five cases where the aggregate losses to investors exceed $30 million.

And second, the States have stepped up their efforts against financial planner fraud and abuse. Evident in the survey of the States is a rapid acceleration in the rate of the States filing actions against financial planners. Over half of the 2-year enforcement actions were settled or opened in the first half of 1988. And criminal prosecutions are becoming much more common at the state level. In our survey of the States, some 42 percent of the cases involved criminal prosecutions.

The State securities agencies drive against financial planning fraud is fueled in part by the new NASAA model laws and regulations. They were developed in consultation with the Division of Investment Management at the SEC. They have already been adopted in Georgia, South Dakota, Virginia, and North Carolina. We expect several States to consider the new laws next year, including California and New York.

The model laws and the regulations are really a complete, comprehensive package that will provide for a much tighter scrutiny and review of the conduct of financial planners than has been possible under existing Federal and early State laws and rules. Significantly, the model laws regulate financial planners under the in-

vestment adviser laws, so long as they give investment advice. They provide for the registration of investment adviser representatives, and they require testing of investment advisers and their representatives. The incredible increase in the number of persons involved in the financial planning business over the last several years has led also to a highly coordinated State and Federal approach to investor protection in this arena.

We are extraordinarily grateful for the cooperative relationship that we have forged with Kathie McGrath and her staff in the Division of Investment Management at the SEC. The SEC has given crucial and necessary assistance to the States in developing a financial scheme for more effective regulation and a better regulatory system.

In conclusion, we should not underestimate the risks of consumers of financial planner fraud and abuse. As our survey indicates, it is already there; however, the States are now serving fair warning that we intend to make this industry far less lucrative to those who use it for fraudulent or abusive purposes. Thank you.

[Complete prepared statement of James. C. Meyer follows.]

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

NASAA

STATEMENT OF JAMES C. MEYER

PRESIDENT,
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

before the
SUBCOMMITTEE ON CONSUMER AFFAIRS
Committee on Banking, Housing and Urban Affairs
U.S. Senate

July 26, 1988

Mr. Chairman and Members of the Subcommittee:

My name is James C. Meyer. I am president of the North American Securities Administrators Association ("NASAA") and director of the Tennessee Division of Securities. NASAA's members are the agencies that supervise the securities industry, regulate the capital markets, and enforce investor protection statutes in the 50 states. I appreciate the opportunity to appear before you today.

Mr. Chairman, I commend you for addressing what has emerged as an increasingly serious problem for average consumers today: Fraud and abuse in the financial planning industry. State securities agencies around the country have their hands full with a growing number of financial planner investigations involving rapidly escalating investor losses. NASAA's 1985 survey of financial planner fraud and abuse uncovered cases that involved $91 million in lost investor funds. When we updated that survey for this Subcommittee, we found a staggering $400 million in investor losses -- a three-fold increase in just three short years.

How can we account for this sharp increase in reported financial planner fraud? It seems apparent that two trends have converged to drive up these figures.

First, there has been an actual increase in the level of fraud and abuse committed by self-proclaimed and registered financial planners. Evidence of this is demonstrated by a substantial number of recent cases where aggregate investor losses were in the "eight figure" range. While we found only one case in 1985 that involved investor losses in excess of $20 million, the 1988 survey uncovered five instances where losses totalled at least $30 million, including a $45 million case in Illinois; a $55 million case in New York; and a $30 million case in Oregon.

The second trend behind the rise in uncovered fraud and abuse is the stepped up state vigilance over, and regulation of, the financial planning industry. The increase in the number of reported state enforcement actions is a tribute to the new activism of state securities agencies to protect consumers from financial planning fraud and abuse.

We are concerned however, that the financial planning problem may get worse, for at least two reasons. First, deregulation of the financial marketplace has created a thicket of instruments in which con artists can hide their financial planning swindles. And, second, the stock market crash of 1987 has sent thousands of investors, who have lost faith in their own judgement, into the arms of financial planners. The combination of these two factors may be a prescription for even greater

future losses due to financial planner fraud and abuse.

At the same time, there is real hope on the horizon for investors in a growing trend for tighter state regulation of financial planners. The greatest impetus for the new state action has come in the form of model investment adviser laws and regulations developed by NASAA. The model laws and regulations are currently in place in four states and under consideration in several others. Significantly, two of the four states to adopt the model investment adviser laws previously had no laws governing the activity of investment advisers.

The NASAA Investment Adviser Model Laws ("Model Laws") clarify that financial planners engaged in investment advisory services must register with the state as investment advisers; require that investment adviser representatives, in addition to investment adviser firms, register with the state; and include express civil liability provisions specifically tailored to investment advisory practices.

The Model Regulations ("Model Regulations") developed by NASAA require net capital and recordkeeping requirements for investment advisers; provide for testing of investment advisers and their representatives; require written disclosure to clients regarding issues such as the qualification of the investment adviser, conflicts of interest, services offered and fees charged; and include a code of ethics for investment advisers.

The staces have not only strengthened their laws and stepped up enforcement efforts, but through NASAA have also developed more sophisticated educational programs to alert consumers to the pitfalls of financial planning and to urge them to exercise caution when choosing a planner or investment adviser. NASAA has worked to develop a range of investor awareness publications, videotapes and seminars for use with groups at high risk of financial planner fraud, including the elderly and professionals.

NASAA has also undertaken several joint projects with the Securities and Exchange Commission ("SEC") to more effectively coordinate state and federal investment adviser regulatory and enforcement efforts. The result is a more rational allocation of the limited resources available to stem a rising tide of fraud and abuse in the financial planning field.

GROWTH IN THE INDUSTRY

Until fairly recently, financial service companies -- banks, brokerage houses, insurance companies and realtors -- each provided different services through a segmented industry. Brokers sold stocks, insurers sold insurance and banks accepted

deposits. As financial services become increasingly consolidated through deregulation, a variety of types of companies are rushing to dominate the investment markets. And, they have discovered that offering financial planning services can help to keep traditional customers and lure new ones.

While financial planning services used to cater primarily to people of considerable wealth, they are now promoted to millions of people with more modest means. Why? Financial planners recognize that the aging American population is concerned about maintaining financial security in later years; that young professionals and two income families worry about funding a child's education and buying a home; and that consumers generally are confused by the dazzling menu of new financial products made possible by deregulation. While the amount of money these individuals may have available to invest is smaller, the total market is large.

In 1987, the International Association for Financial Planning ("IAFP") reported that 13 percent of all Americans now use financial planners and that they fully expected that number to double before 1990. SEC figures show that total assets managed by registered investment advisers increased over 165 percent between 1981 and 1986, from $450 billion to over $1.2 trillion.

The dramatic rise in the number of investment advisers registered with the SEC illustrates the growing trend of financial companies toward establishing financial planning/investment advisory services. In seven years, from October 1980 to October 1987, the number of registered investment advisers with the SEC rose from 4,580 to 12,700 -- an increase of 173 percent. And keep in mind, SEC figures reflect only the number of firms, not the number of individuals, offering these services.

Likewise, financial planner trade associations have reported a sharp increase in membership. IAFP, the largest of these trade associations with over 25,000 members, observed a doubling of its membership in the two year period between September 1982 and September 1984. Similarly, enrollment in the Certified Financial Planner ("CFP") curriculum offered by the College for Financial Planning, sister organization to the Institute of Certified Financial Planners ("ICFP"), has seen a marked increase in candidates for the CFP designation, up over 350 percent in a six year period, from 6,654 in 1980 to 23,480 in 1986.

The Consumer Federation of America ("CFA"), in its July 1987 report, Financial Planning Abuses: A Growing Problem, concludes based on its research that, using a broad definition of a planner, "there are at least 250,000 and possibly as many as

400,000 individuals nationally who list themselves as financial planners in the yellow pages."[1]

The aggressive advertising and promotion of the financial planning concept has led to some uncertainty among the public as to what financial planning is and what a financial planner does. That uncertainty has allowed numerous individuals in the financial services professions, as well as out-and-out con men, to mislead the public by claiming to be financial planners when in fact they have neither the credentials nor the professional expertise necessary to provide that service.

COMMON FRAUDS AND ABUSES IN THE INDUSTRY

There are many honest, skilled people doing excellent work today as financial planners. Reputable financial planners provide a service that can be of use to thousands -- if not millions -- of Americans. But it is equally apparent that this industry can also provide "deep cover" for a substantial number of swindlers, con artists and abusive or unethical promoters.

Five common frauds and abuses in the financial planning industry are:

1. Unqualified Planners/Advisers

Currently, SEC investment adviser registration does not require that an applicant satisfy any formal minimum professional or educational standards. Yet, to fulfill the promise of developing a comprehensive and personalized financial plan, you would need a wide-ranging knowledge of taxes, life and health insurance, trusts, pensions, real estate, stocks, bonds, limited partnerships, and other investment vehicles. The evidence suggests that most planners have background experience in only one of these many areas, usually insurance or securities.

A recent membership survey of The IAFP revealed that 30 percent of its members enter the financial planning field with a background in insurance, while an additional 27 percent come from the securities industry. Not only do a majority of planners and advisers have limited exposure to all the disciplines necessary for drawing up a comprehensive plan, most planners practice alone or in smaller firms where they are unlikely to have as resources a team of colleagues experienced in the multitude of areas covered by a financial plan.

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[1] Financial Planning Abuses: A Growing Problem, A Report of the Consumer Federation of America [Barbara Roper, author], July 1987, page 11.

The SEC's February 1988 staff report, Financial Planners ("SEC Report"), reveals that "most financial planners either work alone or work in small business organizations." The SEC Report cites member surveys conducted by financial planner professional associations which disclose that at least half the members work in organizations of ten or fewer employees. The SEC's ADV Database shows that the average number of investment advisory employees for each adviser is 3.1, and that each financial planner has an average of 2.7 employees.

Furthermore, the SEC Report concludes that "the information that exists concerning the experience of financial planners suggests that many planners, perhaps even a majority, are fairly new to the planning business." With the notable exception of the survey of the American Society of Certified Life Underwriters and Chartered Financial Consultants, which reported that members were in the planning business for an average of 19 years, surveys of financial planners indicated that a majority of the planners had been in the business for less than ten years.

We recognize the contribution of financial planner professional associations in promoting educational programs for planners. For example, to become a Certified Financial Planner ("CFP") a candidate must meet certain education, examination, and experience requirements. The Institute of Certified Financial Planners is a voluntary membership organization for financial planners with the CFP designation. A certifying board, the International Board of Standards and Practices for Certified Financial Planners ("IBCFP"), was established in 1985 to serve as the professional standards-setting organization of CFPs. In addition to certifying CFP registrants, the IBCFP has established minimum standards for experience and continuing education and has adopted a Code of Ethics and Standards of Practice and Disciplinary Rules and Procedures.

In order to use the Chartered Financial Analyst ("CFA") designation awarded by the Institute of Chartered Financial Analysts, candidates must successfully complete three examinations, have three years experience, and comply with a code of ethics and standards of professional conduct. The Registry of Financial Planning Practitioners, administered by the International Association for Financial Planning, also requires that registrants meet certain threshold levels of education, experience and knowledge.

While we appreciate that compliance with the standards established by these professional organizations is beneficial, the fact remains that membership in these organizations is voluntary and control over members limited.

2. "Product-Driven" Planners/Advisers

One of the biggest surprises consumers may discover in a relationship with a financial planner/investment adviser is that the advice given or the plan drawn up is calculated to encourage the consumer to purchase products recommended by the planner or adviser. While financial planning or investment advice may be a service, very few planners simply "plan" and very few investment advisers simply "advise." Most planners/advisers implement the recommendations of the plan and therefore get involved in product sales. What too many consumers have learned is that the planner/adviser had a hidden agenda to sell financial products that earn him or her substantial commissions -- even if the recommendation was not appropriate for the client's needs or goals.

The SEC Report described the typical situation: "Once the client is presented with the plan, the implementation of the plan includes the purchase of investment or insurance products specifically recommended by the planner, often from a product sales organization affiliated with the planner. The planner may be affiliated with a broker-dealer, an insurance company or both. And the planner's remuneration from the client may come more from commissions on the sale of products than from the fees generated by the preparation of the plan."

The SEC Special Planner Inspections found that 85 percent of active planners were affiliated with an organization that sold financial products. Employee time in the inspected firms was devoted more heavily to product sales than to planning. The IAFP's 1985 membership survey revealed that 64 percent of the average planner's gross revenue comes from commissions.

Many consumers would be equally alarmed to learn that their planner or adviser had recommended an investment strategy based on participation in a contest conducted by a product sponsor. For example, not long ago the Wall Street Journal reported that the "star attraction" at a convention of financial planners was a red Porsche. Planners attending the convention heard representatives of Oppenheimer Management Corporation promote three new mutual funds. The incentive to sell the mutual funds: whoever reached the highest total sales by the end of the year would win the choice of a Porsche 944 Turbo, a Jaguar XJ-S or a Corvette. Apparently it is not uncommon for product sponsors to offer sales incentives, such as prizes or trips, to planners, stockbrokers and insurance salespeople.

The Wall Street Journal concluded that the "evidence is clear that some planners, brokers and others who sell investment products respond to the contests. Product sponsors say sales go up when a contest is offered, and often fall off when one is not

offered. Some planners ask about the current contest along with details about the investment."

It may be impossible for consumers to know whether the products a planner or adviser recommends are part of a sales incentive contest. You cannot fairly inquire about a contest-induced recommendation if you do not know that the contest is taking place. We are pleased that some financial planners and their trade associations share our concern about contest-induced investment recommendations and have issued policies concerning the acceptance of sales incentives, including disclosure of the incentive to customers.

3. Lack of Disclosure

The cornerstone of federal securities laws and regulations, including investment adviser regulation, rests on the notion of full and fair disclosure. Indeed, federal regulation relies exclusively on disclosure to address concerns over the competency and dependability of the adviser.

The SEC's Rule 204-3, commonly referred to as the "brochure rule," is intended to provide a basic element of preventive consumer protection by requiring registered investment advisers (and those required to register) to furnish clients or prospective clients with written disclosure about the planner/adviser and its operations at the time of, or before, entering into the advisory agreement. A similar, updated document is to be furnished, or at least offered in writing, to clients on an annual basis thereafter.

The brochure provided to consumers consists of Part II of the federal registration Form ADV, or its equivalent. This required disclosure is intended to provide consumers with the information needed to evaluate the adviser's qualifications, investment methods and the potential areas of conflicts-of-interest.

In theory, the rather lengthy laundry list of items included in the required federal disclosure should satisfy any consumer's need for basic information concerning an investment adviser. In reality, surveys indicate that the disclosure is not routinely provided, and that in some instances the disclosure has evolved into little more than a slick advertising brochure for the adviser.

A recent survey of subscribers to Sylvia Porter's Personal Finance Magazine, conducted on behalf of the ICFP, reveals that, of those responding, only 27 percent received a disclosure document from the planner. The SEC Special Planner Inspections found that, while 85 percent of the planners actually sold products to clients, only 47 percent informed prospective

clients that they sold financial products. Clearly, there is less than universal compliance with the disclosure requirements.

Another problem arises when advisers/planners do not provide clients with Part II of Form ADV but choose instead to exercise their right to provide the "equivalent" of Part II. Certainly the intent here is to allow advisers/planners to design their own documents that contain the same information as that contained in the registration form. However, we are concerned that the documents developed by some advisers/planners have less to do with disclosure about conflicts of interest, educational and disciplinary background, as with promoting the services of the planner/adviser. We have seen some disclosure brochures that could not have been designed with any intent other than to lure clients.

4. Con Artists

The cases involving out-and-out con artists who use the guise of financial planning as the perfect "deep cover" to dress up their schemes to defraud unwitting consumers are plentiful. These swindlers never intend to actually provide financial planning or investment advisory services, but rather use the financial planner label to gain and then exploit customer confidence. These con men hold themselves out as financial planners as a way to gain custody of client funds, sell phony securities, run Ponzi-type operations or simply misappropriate client assets -- all to their own use and benefit. Their clients often end up with nothing but worthless stock certificates, dashed expectations and financial ruin.

The CFA Report concluded that "financial planning is currently practiced and regulated in a way that makes abuse easier to practice than to detect. Because there are no governmental limits on who can call himself a financial planner, this financially attractive industry is wide open for exploitation by individuals and firms that either cannot offer or have no interest in offering comprehensive, objective financial advice."[2]

Surely no amount of governmental regulation will ever relieve us of con artists who operate outside of the law. However, the existence of a strong regulatory program, duly publicized and enforced, will assist in the swift detection and prosecution of con artists and will put consumers on notice that they should exercise caution when choosing a financial planner or investment adviser.

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[2] CFA Report, p.40.

5. Moonlighters

A "moonlighter" refers to someone who sets up a financial planning or investment advisory business separate and distinct from his employing firm. A moonlighter may capitalize on his employment relationship with an established brokerage, insurance or realty firm as a lure to attract customers to the planning or advisory business. Borrowing on the credibility of an affiliation with an established firm, moonlighters can convince customers of their financial expertise or business acumen.

The existing employment relationship may then be used to sell products recommended to the planning or advisory business customers. Operating off the premises of the employing firm, the planning or advisory services of a moonlighter may not be detected by the day-to-day supervisory oversight of the employing firm.

A moonlighter may then use the financial planning or investment advisory business to sell unregistered securities, participations in short term loans, interests in investment pools, or phony real estate ventures. The proceeds of these investments seldom end up in the initial enterprise but often end up in the pockets of the moonlighter.

SCOPE OF THE ABUSES

A just-completed review of 79 major enforcement actions carried out by 30 state securities agencies revealed that, over a two-year period, more than 22,000 investors lost a staggering $400 million as a result of fraud and abuse in the financial planning industry. The survey conducted by NASAA included enforcement actions from mid-1986 to mid-1988. Attached to this testimony is a report, The NASAA Survey of Fraud and Abuse in the Financial Planning Industry ("NASAA Survey"), which details the findings of our survey.

The extent of recent financial planner fraud and abuse described in the 1988 NASAA Survey was up sharply from that detected in a 1985 Association survey, which found that investors lost $91 million in 31 cases handled by state securities divisions. A comparison of the two NASAA surveys indicates that the number of state actions against financial planners rose 155 percent and the amount of lost investor funds climbed 340 percent.

Two major explanations are offered for the recent surge in financial planner fraud and abuse cases handled by state securities agencies:

- There has been an alarming rise in "big ticket" swindles carried out under the guise of financial planning. While only one case in the 1985 NASAA survey involved investor losses in excess of $20 million, states have taken action since mid-1986 against five major financial planning scams involving at least $30 million each in investor losses.

- State securities agencies have mounted a major "get tough" effort against financial planner fraud and abuse. The 1988 NASAA Survey found that criminal prosecution was an element in 42 percent of cases, an extremely high percentage for white-collar offenses. A total of 19 sentences providing for 300 years in prison and $3 million in restitution already have been handed down at the state level against financial planners.

STATE-FEDERAL REGULATORY STRUCTURE

The dual scheme of securities regulation in the United States, in which the federal and state regulatory programs complement one another, promotes individual investor safeguards and market integrity through federal action to set minimum standards while states may employ more substantive requirements.

State securities regulation dates back more than two decades before the creation of the SEC. The first modern "blue sky" law, adopted in 1911 in Kansas, served as the model for other states as they soon followed with their own laws requiring the registration of securities offerings and the licensing of broker-dealers and their agents. The dual system of state and federal regulation of the securities markets began in the 1930s, when Congress adopted the first federal securities laws. Regulation of the burgeoning investment adviser and financial planning industry exemplifies why a coordinated state-federal regulatory approach is necessary for the adequate protection of investors.

An effective securities regulatory scheme must include a comprehensive three-part program consisting of: prevention, detection and prosecution. If one or more of these main elements is not fully incorporated, the regulatory system is incomplete. This is the experience the states brought to the table when drafting the NASAA Model Investment Adviser Laws and Regulations. At the same time, the shortcomings in the traditional federal program of regulating investment advisers

provided additional incentive for the states to develop a more comprehenisve state program.

Federal Role

Federal regulation of investment advisers is governed by the provisions of the Investment Advisers Act of 1940 ["Advisers Act"]. The Advisers Act requires almost all investment advisers, including financial planners, to register with the SEC. There are no federal testing requirements, minimum education requirements or continuing education requirements applicable to advisers or financial planners. A registrant must pay a fee, fill out the proper forms, and wait 45 days for it to be processed. Only in very limited instances is registration denied.

The definition of "adviser" under the federal law includes "any person who, for compensation, engages in the business of advising others ... as to the value of securities or as to the advisability of investing in, purchasing, or selling securities ...." In two releases issued by the Commission, Release 770 in 1981 and Release 1092 in 1987, the Commission has clarified the applicability of the Advisers Act to financial planners and other persons who provide investment advice as a component of other financial services. Generally, the broad construction of the investment adviser definition brings under its umbrella most financial planners or consultants.

Registered investment advisers are subject to administrative oversight by the SEC, including submission to periodic inspections by SEC examiners and the institution of administrative proceedings against the adviser for violations of the Act. The Act also imposes on advisers a fiduciary duty to clients; certain substantive obligations, including disclosure requirements; and recordkeeping requirements.

The Commission, which does not impose minimum qualification standards on applicants, has no means by which to screen out even the most inexperienced or fly-by-night operator from gaining access to the public trust under the financial planner/investment adviser rubric. Even worse, the federal registration process is used in many cases to create an air of legitimacy to the abusive or fraudulent planner/adviser since it is so easy to become a "registered" investment adviser. The 1988 NASAA Survey turned up more than half a dozen major fraud cases involving financial planners who were registered as investment advisers with the SEC.

The U.S. Supreme Court's refusal to recognize an implied private cause of action for damages under the anti-fraud

provisions of the Advisers Act[3] precludes victims of investment adviser abuse from invoking the protection of the much-heralded fiduciary duty of the adviser toward his client. This is turn places a greater premium and demand on SEC enforcement resources if the concept of the adviser's fiduciary duty is to be meaningfully enforced.

State Role

That there are weaknesses in a federal law based on disclosure should come as no surprise. Many of the first generation state investment adviser laws counter the loose federal scheme by including elements of a more complete regulatory program. And, the NASAA Model Investment Adviser Laws and Regulations are crafted to compensate for the federal weaknesses by incorporating three essential elements: prevention, detection and prosecution.

Forty states[4] provide for the registration and regulation of investment advisers and/or financial planners who fall within the investment adviser definition. Of the 11 states (including the District of Columbia) that do not currently require the registration of investment advisers, five are considering such legislation.[5]

Most states define "investment adviser" in a manner similar to that used in the federal Investment Adviser Act of 1940. NASAA and the SEC jointly developed Release 1092 concerning the applicability of investment adviser registration requirements to financial planners and other persons who provide investment advice as a component of other financial services. Other similarities in the current state and federal laws include the anti-fraud provisions and recordkeeping requirements.

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[3] Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979).

[4] States that require the registration of investment advisers include: Alaska, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wisconsin.

[5] Investment adviser regulation is under consideration in: Alabama, District of Columbia, Maryland, Massachusetts and Ohio.

However, despite these corresponding provisions, it is the additional state requirements imposed on investment advisers that highlight how state laws serve as an important supplement to the shortfalls of the federal Investment Advisers Act.

Twenty-one[6] of the 40 states that currently regulate the activities of investment advisers also require that investment adviser representatives register. Under federal regulation, only firms are subject to the registration requirements; individuals are not. Registering investment adviser representatives is an important component of state regulation because it brings under the regulatory structure those individuals who deal directly with consumers.

A significant preventive device granted to most state securities agencies is the authority to consider the training, experience and knowledge of an investment adviser applicant and the authority to require an examination of such applicant as a condition of registration. Currently, 28 states assert this prerogative by setting standards of experience, education and/or successful completion of certain examinations to assure some minimum measure of competence on the part of the persons holding themselves out to the public as experts in the investment advisory field.

Nineteen states require some demonstration of financial stability by requiring an investment adviser to meet certain net capital, net worth, or net tangible asset standards and/or produce a surety bond in a specified amount. An additional eight states impose such requirements if the adviser accepts custody, discretionary authority or prepaid fees from clients.

With respect to prosecution and deterrence, most state investment adviser laws include somewhat broader anti-fraud provisions. This is accomplished by substitution of "any person" for "any investment adviser" in the language preceding the fraudulent practices provisions. The result is that the state anti-fraud provisions reach anyone receiving compensation for advice on the value, purchase or sale of a security, whether or not the individual is "in the business" or otherwise excluded from the definition of investment adviser.

The states are not hesitant to use the prevention detection and prosecution authority granted to them under their investment adviser laws. Evident in the 1988 NASAA Survey is a rapid

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[6] States that require registration of investment adviser representatives include: Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Kansas, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Utah, Virginia, Washington and Wisconsin.

acceleration in the rate of the filing of state actions against financial planners. More than half of the 79 cases filed in the past two years have come during the first seven months of 1988. The first year of the survey (mid-1986 to mid-1987) accounted for a total of 23 cases or just 29 percent of the total number of actions undertaken during the entire survey period. The second year (mid-1987 to mid-1988) saw a 140 percent jump in state actions, to 56 major cases. The pace seems to be yet still quickening, with 43 of the investigations -- or 54.4 percent of the two year total -- settled or opened in the first half of 1988.

Further evidence of the state assertion in the battle to combat financial planning fraud and abuse is demonstrated in the NASAA Survey findings. A total of 300 years of prison sentences involving financial planners were imposed in 13 cases, including the 222 year sentence of a Virginia financial planner who embezzled $1.3 million from 40 investors in eight states. Criminal prosecution was either underway or planned in another 20 of the state cases. The 33 financial planner fraud cases involving criminal prosecution accounted for 42 percent of the major state actions included in the 1988 NASAA Survey.

NASAA Model Laws and Rules

The NASAA model investment adviser laws and regulations represent the most comprehensive and complete package for the regulation of financial planners and investment advisers. A three-part program incorporating the key elements of prevention, detection and prosecution, the model laws and regulations were crafted to compensate for the inherent weaknesses in the looser federal regulatory system.

Adopted in 1986 and 1987 respectively, the model laws and regulations promulgated by NASAA have already been adopted in four states: Virginia, South Dakota, Georgia and North Carolina. Consideration of the model laws is expected next year in several additional states.

The NASAA model significantly expands the registration requirement under state investment adviser laws. Under the model law, all financial planners who engage in investment advisory services are required to register. Investment adviser representatives, and not just firms, are required to register -- after all, firms rarely defraud investors while individuals do. In addition, investment advisers, their representatives, and financial planners will all have to satisfy a testing requirement. NASAA has been working to develop a uniform examination for implementation of the testing requirement; we expect to have it available to the states by early Fall.

Casting a wider net for the registration requirements, and requiring a demonstrated knowledge of the subject area through testing, are important preventive tools contained in the NASAA model laws and regulations. The states can use this authority to screen out abusive and fraudulent planners or advisers before they victimize unknowing investors. Additionally, consumers will have a valuable information resource to consult before choosing a planner or adviser. Rather than find out too late that a planner or adviser operated outside of the regulatory structure, consumers can call state securities agencies for registration information.

The model laws and regulations will significantly assist the states in their efforts to detect and prosecute financial planning fraud and abuse. The enhanced regulatory system under the model includes:

- express civil liability specifically tailored to investment advisory practices;
- net capital rules;
- recordkeeping requirements;
- written disclosure to clients regarding such issues as the qualification of the investment adviser, conflicts of interest, services offered and fees charged; and
- a detailed code of ethics for investment advisers.

The comprehensive investment adviser regulatory program developed by NASAA reflects the traditional commitment of the states to protect consumers before they part with their money; and if they do lose their money in a fraudulent deal, to marshal the enforcement resources in an aggressive campaign to shut down the violator. As more and more states take up the challenge of regulating the conduct of financial planners, we expect that this industry will be far less lucrative to those who use it for fraudulent or abusive purposes.

Joint State-SEC Efforts

The rapid growth in the financial planning and investment advisory industry has led to a highly coordinated state-federal approach to investor protection. Highlights of the joint state-SEC efforts include:

- SEC staff assistance to the states as we drafted the model investment adviser laws and regulations;

- joint development of a release clarifying the applicability of investment adviser laws to financial planners;

- the creation of a training program conducted by the SEC for state personnel involved with investment adviser inspections;

- a twenty state-SEC inspection program whereby state and federal auditors jointly inspect investment advisers; and

- continuing discussions between the SEC and NASAA to work out the details of a proposed Commission rule, which if adopted, would establish a series of exemptions from federal registration requirements for certain state-registered investment advisers.

INSPECTION PROGRAMS

There is no doubt that a vigilant oversight program both detects violators and deters would-be violators. Certainly, the inspection programs at the state and federal level are important components of investment adviser regulation.

The SEC Report includes an illuminating picture of the Commission's inspection program. While the percentage of investment advisers inspected annually between 1982 and 1987 declined, the SEC observed that the decline "is the result of the rapid growth in the adviser population rather than a decrease in the productivity of the inspection staff." Actually, the SEC Report argues that the productivity of the inspection staff has increased more than 156 percent in seven years, from 10.6 inspections per staff year in 1980 to 27.1 in 1987. The Commission staff should be commended for seeking to maintain an inspection program that will deter violations, despite strained resources.

According to the SEC Report, the scope and focus of adviser inspections has been increasingly tailored to mirror the perceived risk in a particular adviser's operation. Investment advisers determined to pose a risk to client assets and new advisers are targeted for inspection. However, the House Energy and Commerce Committee report accompanying the 1987 SEC Authorization, pointed out that during 1986 the Commission managed to inspect between only 20-25 percent of those investment advisers it targeted as presenting "higher risks" to clients.

State securities agencies also conduct inspections of registered investment advisers. As state agencies continue to focus increasing attention on the problems in the financial

planning and investment advisory industry, we fully expect that state oversight efforts will expand as well.

The State of Connecticut's Securities Division operates an especially extensive and effective investment adviser inspection program. The program, which began ten years ago, concentrates solely on investment advisers located in the State. Prior to an effective registration, registrants meet with Securities Division staff to discuss the requirements they must comply with as a registered investment adviser. The staff in the Securities Division report that this personal exchange is extremely helpful and reaps future benefits in terms of compliance with the law.

New registrants are inspected within their first year of operation. After that, investment advisers are inspected every two to three years. Similar to the results of the SEC inspection program, the most common problems uncovered in Connecticut's investment adviser inspections involve a failure to maintain adequate books and records.

The states and the SEC recognize the value of sharing information and coordinating inspection efforts. Under a joint state-federal inspection and training program SEC staff has trained examiners in 20 states. Additionally, inspection schedules and findings are exchanged between the SEC and the states in an effort to increase inspection coverage and minimize duplication.

It has been proven repeatedly that an aggressive inspection program deters abusive practices in the securities field. Yet, both the SEC and state agencies must struggle to maintain effective inspection programs of registered investment advisers because of woefully inadequate resources. We fully expect that the states and the SEC will continue to work together to ensure that scarce resources are used as efficiently as possible.

ADDITIONAL REGULATORY AUTHORITY

It is clear that regulation of investment advisers and financial planners would be significantly improved if laws were strengthened and adequate resources applied to enforce the laws. NASAA suggests that consumers will benefit if:

- State securities agencies amend their laws to expand the scope of regulation, as contained in the NASAA Model Investment Adviser Law and Regulations;

- The SEC budget devoted to investment management programs is substantially increased to reflect the dramatic rise in the number of registered investment advisers;

- Laws which restrict the free exchange of information between the SEC and the states are amended to reflect the existing informal process of coordinating efforts; and

- Congress establishes a self-regulatory organization for investment advisers.

NASAA Model Investment Adviser Laws

The NASAA Model Investment Adviser Laws and Regulations were discussed in detail earlier in this testimony. However, it should be emphasized once again that the adoption of this comprehensive package will significantly extend the reach of state regulation and enhance enforcement capabilities. The states have expressed a commitment to strengthen laws and regulations so that consumers are less susceptible to the types of financial planner fraud and abuse uncovered in NASAA's 1988 survey.

Increased SEC Resources

During the 1987 authorization hearings, the Commission noted that, due to a rapid growth in the number of registered investment advisers, "providing an adequate level of protection has become increasingly difficult." The Energy and Commerce Committee of the U.S. House of Representatives also expressed concern that the resources of the Investment Management Division simply have not kept pace with the responsibilities assigned to the Division -- namely, minimizing the risk of investor loss through the regulation and review of disclosure by investment advisers.

We urge this Subcommittee and the Senate to seriously consider a substantial increase in Commission funding devoted to regulating investment advisers. The evidence clearly shows that the very able staff in the Investment Management Division cannot continue to squeeze increasing productivity out of its limited staff indefinitely.

SEC-State Cooperation

NASAA is pleased with the level of cooperation and coordination between the Commission and states concerning the regulation of investment advisers. However, we believe this arrangement will improve if Congress adopts a proposal offered two years ago by then-SEC Chairman John Shad.

Testifying at a financial planner oversight hearing, Chairman Shad explained that Section 210(b) of the Advisers Act prohibits Commission members and staff from disclosing

information about an investment adviser examination, investigation, or inspection, absent Commission approval, except in certain limited instances.

In his statement, Shad explained why the law needed to be amended:

> "the process of seeking Commission approval adds costs in terms of staff and Commission time. Delays caused by this process can result in unnecessary duplication of Commission investigative work by the states and other law enforcement authorities. Moreover, malefactors may continue to commit fraud or otherwise violate the law in other jurisdictions during the pendency of an SEC investigation or inspection."

We recommend that Congress amend Section 210(b) by adding a new paragraph (3) to provide an exclusion from the information sharing restriction "in the case of any state, federal, or foreign government official or agency for law enforcement or regulatory purposes."

Self-Regulatory Organization

In March 1986, the NASAA membership adopted a resolution supporting the establishment of an investment adviser self-regulatory organization ("SRO"), so long as:

- any such SRO is both responsive to and directly accountable to the states as well as the SEC;

- any such SRO be both functionally sound and adequately funded; and

- any such SRO is not inconsistent with, and further, accommodates existing state investment advisers laws as may be amended.

We view with interest the resolution adopted by the National Association of Securities Dealers' ("NASD") Board of Governors at a meeting last May, proposing that the NASD take steps to become the SRO with jurisdiction over the investment advisory activities of NASD members and affiliates who are registered investment advisers. Apparently, nearly half of the SEC registered advisers are also either registered with SEC as broker-dealers or are affiliated persons of registered broker-dealers.

Certainly the NASD would bring readily available expertise and resources quickly to bear on the estimated 7,000 investment advisers such a proposal would cover. However, NASAA believes that it is premature to specifically recommend one SRO proposal over another. While we agree that the NASD is an experienced SRO

for broker-dealers, we would recommend that this issue be further considered before recommendations are offered.

CONCLUSION

Financial planning has been one of the leading growth industries of the 1980s -- today, an ever increasing number of bankers, brokers, insurers, realtors and tax planners do business under a common title: financial planner. The lack of effective national oversight of the financial planning industry has created a tremendous opportunity for con artists and others who operate on the fringe of legitimacy. Investment swindlers have been quick to make the most of the gaps in federal oversight of the financial planning industry.

A just-completed survey of state enforcement actions revealed that, over a two-year period, more than 22,000 investors lost a staggering $400 million as a result of fraud and abuse in the financial planning industry. That is more than a three-fold increase over the $91 million in investor losses uncovered in a similar survey just three short years ago.

But the message is not all "gloom and doom" for consumers. The increase in the number of reported state enforcement actions reflects the new activism of state securities agencies to protect investors from financial planning fraud and abuse. The drive by state securities agencies against financial planning fraud is fueled by the new NASAA model laws and regulations already adopted in Virginia, South Dakota, Georgia and North Carolina.

This "second generation" of consumer protection standards now being put in place by the states provides for much tighter scrutiny and review of the conduct of financial planners than has ever been possible under existing federal and earlier state laws and rules.

North American Securities Administrators Association

NASAA

Report to the Subcommittee on Consumer Affairs, Committee on Banking, Housing and Urban Affairs, U.S. Senate

July 1988

THE NASAA SURVEY OF FRAUD AND ABUSE IN THE FINANCIAL PLANNING INDUSTRY

30-State Survey of Recent State Enforcement Actions Reveals $400 Million in Investor Losses; Scale of Fraud Up Sharply From $91 Million in Earlier Survey

NASAA 555 New Jersey Avenue NW Suite 750 Washington, D.C. 20001

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EXECUTIVE SUMMARY

More than 22,000 investors lost $400 million as a result of fraud and abuse in the financial planning industry over a two-year period from mid-1986 to mid-1988, according to a North American Securities Administrators Association (NASAA)[1] survey of 79 enforcement actions carried out by 30 state securities agencies. The extent of recent financial planner fraud uncovered in the 1988 NASAA Survey was up sharply from that detected in a 1985 Association study, which found roughly $91 million in investor losses in 31 cases handled by state securities divisions. A comparison of the two NASAA Surveys indicates that the number of state actions against financial planners rose 155 percent and the amount of lost investor funds climbed 340 percent.

Two developments contributed to the recent surge in financial planner fraud and abuse cases handled by state securities agencies:

- o There has been an alarming rise in "big ticket" swindles carried out under the guise of financial planning. While only one case in the 1985 NASAA Survey involved aggregate investor losses in excess of $20 million, states have taken action in the last two years against five major financial planning scams involving aggregate investor losses of at least $30 million in each case. The rapid growth of the loosely regulated financial planning industry appears to have had the unintended side-effect of paving the way for the swindlers and unscrupulous promoters who pose as financial planners.

- o State securities agencies have mounted a major "get tough" effort against financial planner fraud and abuse. The states have stepped up criminal prosecutions of unscrupulous financial planners and also are being armed with a new generation of tough new laws and regulations aimed at "bad apple" financial planners. Criminal prosecution was an element in 42 percent of the recent cases, a high percentage for white-collar offenses. Thirteen criminal convictions

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[1] NASAA is the national organization of state securities administrators.

arising from state investigations of financial planners resulted in sentences providing for 300 years in prison. Court and state rescission orders have returned $3 million to investors. The drive by state securities agencies against financial planning fraud also is being fueled by new NASAA model laws and regulations already adopted in Georgia, South Dakota, Virginia and North Carolina and is or has been under consideration in more than half a dozen other states, including New York and California. The "new generation" of consumer protection standards now being put in place by the states provides for much tighter scrutiny and review of the conduct of financial planners than has been possible under existing federal and earlier state laws and rules.

Releasing the results of the 1988 NASAA Survey of Fraud and Abuse in the Financial Planning Industry, James C. Meyer, president of NASAA and director of the Tennessee Division of Securities, said: "The message is clear: Unless effective consumer protections are put in place soon, tens of thousands of investors will lose billions of dollars in the next few years."

Copies of the June 26, 1988 statement of Mr. Meyer to the U.S. Senate Consumer Affairs Subcommittee are available by contacting:

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THE RISE OF THE FINANCIAL PLANNING INDUSTRY

A decade ago, most financial service companies and professionals -- banks, brokerage houses, insurance companies, realtors and tax planners -- stuck to their knitting. Brokers sold stock, realtors showed houses and banks accepted deposits and made loans. But the rise in the early 1980s of the financial planning industry, coupled with the deregulation of the financial marketplace, did much to blur the financial services picture. Today, a substantial and ever increasing number of bankers, brokers, insurers, realtors and tax planners do business under a common title: financial planner.

No longer are investment advisers simply confidantes of the well-to-do. Financial planning is now promoted as a basic service of use to tens of millions of middle income Americans, including those with incomes as small as $35,000 a year. It is estimated that well over 10 million Americans consult financial planners today. As the Consumer Federation of America (CFA) noted in a major study of the industry: "As the (financial planning) idea caught on, a number of the large insurance and brokerage firms began offering financial planning services in order to keep their traditional customers and to attract new ones. In particular, these firms began to expand from the upper income to the middle income market. Here, although the amount of money individuals have available to invest is smaller, the total market is large, and the need is great for sound advice on such issues as how to fund a child's college education, how to save to buy a house, and how to prepare for a comfortable retirement."[2]

A massive multi-million-dollar client recruitment effort staged by financial planner trade groups in the early and mid-1980s paid off enormously. Evidence of the recent growth explosion in the financial planning industry is seen in:

- The number of investment adviser firms registered with the federal Securities and Exchange Commission (SEC) rose 173 percent, from 4,580 to 12,700, from October 1970 to the same month in 1987.[3]

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[2] Barbara Roper, "Financial Planning Abuses: A Growing Problem," A Report of the Consumer Federation of America, July 1987.

[3] The SEC figures primarily reflect the number of investment adviser firms, not the much larger number of individuals, offering financial planning services.

- The International Association of Financial Planners, an industry trade group based in Atlanta, now has a total of more than 25,000 members. IAFP membership rolls doubled between September 1982 and September 1984.

- Enrollment in the Certified Financial Planner (CFP) curriculum offered by the College for Certified Financial Planning, the sister organization of the Denver-based Institute of Certified Financial Planners (ICFP), has reported a marked increase in candidates for the CFP designation, up over 350 percent from 6,654 in 1980 to 23,480 in 1986. Professionals from all walks of the financial services industry are being rushed through financial planning "boot camps" in a manner remiscent of the crash build-up of military recruits prior to the start of World War II.

- During the television coverage of the last Winter Olympics, a major brokerage house aired commercials featuring a "financial consultant" -- the term the Wall Street firm now uses to refer to its stockbrokers.

Financial planning may be one of the leading growth industries of the 1980s, but it also is one about which very little is known for certain. For example, there is no clear picture of the total number of financial planners/investment advisers. The fewer than 13,000 investment adviser firms registered with the SEC captures only a small fraction of the ranks of individuals who do business under the rubric "financial planner." The number of Yellow Page listings in California alone for financial planners stood at 60,000 in 1986, according to an investigation by the securities division of the California Department of Corporations. The Consumer Federation of America (CFA) has calculated that there are 400,000 financial planners in the U.S., while other estimates have put the figure at 150,000 to 500,000.

The task of getting a handle on the financial planning industry is complicated by several different factors. One is that the average financial planning firm is small, with fewer than three employees, according to a recent SEC report.[4] The second major factor is that the existing system of SEC oversight of investment advisers sets out no formal minimum professional or educational standards and no testing requirements. As a result, anyone can hang out a shingle and call themselves a financial planner.

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[4] Staff report, Securities and Exchange Commission, "Financial Planners," submitted to the U.S. House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance, February 1988.

The absence of effective national oversight of the financial planning industry has created an enormous opportunity for con artists and those registered brokers and other professionals who have few scruples about how they earn their livings. The rise in the fortunes of legitimate financial planners has been matched by a surge in the activities of those who operate in what has been referred to as the "dark side" of the investment adviser industry. Investment swindlers thrive in the cracks of regulatory frameworks; they have been quick to make the most of the gaps in federal oversight of the financial planning industry.

In response to a growing number of complaints that reached state securities offices in the early 1980s, NASAA convened in March 1985 the first national hearings on problems in the financial planning industry. The 1988 NASAA Survey of Financial Planner Fraud and Abuse was prepared for submission at a July 26, 1988 hearing of the U.S. Senate Consumer Affairs Subcommittee.

KEY FINDINGS OF THE 1988 NASAA SURVEY

The number of major enforcement actions undertaken by state securities agencies against abusive and fraudulent financial planners has risen sharply in recent years. There also has been a dramatic increase in the amount of investor losses to financial planners. A review of 79 state enforcement actions carried out by 30 state securities agencies[5] from mid-1986 to mid-1988 indicates that 22,100 investors lost $396.84 million as a result of fraud and abuse in the financial planning industry. The following is a representative sampling of the state enforcement actions:

- A Richmond financial planner was sentenced in September 1987 to 222 years in prison for a phony investment pool scheme in which he was accused by the Virginia Division of Securities and Retail Franchising of stealing $1.3 million from 40 investors in eight states, including $20,000 taken from his grandmother-in-law.

- An estimated 100 investors lost $3 million to a 15-person financial planning firm that was raided on July 15, 1988 by the securities division of the Missouri Secretary of State. The Kansas City, Mo., firm promoted nonexistent "government-backed bonds" to investors as a means of financing the college education of their children. The state's preliminary investigation of bank records indicates that the financial planning firm has recoverable assets of just $400.

- More than 6,000 Chicago area investors are believed to have lost $45 million to a financial planner now facing action by the Securities Department of the Illinois Secretary of State. Investors nearing retirement age were targeted in the scheme which involved a complex web of trusts and 250 real estate limited partnerships. Investors who attended the promoter's four-night seminar program were promised that they could earn more money <u>after</u> retiring then they were making while working. The state found that investor funds had been diverted into the financial planners purchase of

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[5] The thirty states participating in the 1988 NASAA Survey were Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Idaho, Illinois, Indiana, Maine, Maryland, Massachusetts, Missouri, Nebraska, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Tennessee, Texas, Utah, Virginia, Washington, West Virginia and Wisconsin.

three homes, a 26-foot boat, aircraft, an airport hangar and motor vehicles.

Table I
State-by-State Summary of 1988 NASAA Survey[6]

State	No. Cases	Dollar Losses (millions)	No. Victims
AL	4	$19.28	229
AZ	2	$ .73	61
AR	1	$ 6.	300
CA	4	$14.74	2709
CO	2	$ 3.5	224
CT	1	$ 2.14	---
FL	2	$ .69	38
GA	3	$ 4.26	7
ID	4	$ 2.81	95
IL	2	$53.	6400
IN	4	$ 6.62	63
ME	1	$ 2.	200
MD	2	$ 2.	110
MA	2	$ 1.45	10
MO	3	$33.2	360
NE	3	$10.82	82
NY	1	$55.	950
NC	3	$ 9.6	156
OH	4	$11.67	221
OK	3	$11.01	100
OR	1	$32.	950
PA	2	$15.02	153
TN	1	$ 1.2	40
TX	3	$12.9	337
UT	2	$ .5	100
VA	3	$ 2.36	53
WA	5	$72.35	7630
WV	2	$ 1.45	51
WI	2	$ 2.5	141
TOTALS	79	$396.84	22,099

[6] Complete totals for victims were not available for Connecticut and other states where enforcement actions focused only on the portion of investors who served as the basis for criminal or administrative actions.

- A Marrietta, Ga., man was sentenced on February 19, 1988 to five years in federal prison for a "consumer savings certificate" swindle that resulted in losses of $226,000 for more than 16 investors. An investigation by the Alabama Securities Commission determined that the promoter, the former pastor of a Baptist church in Mobile, Ala., offered "Christian financial planning" to churches and their congregations. The financial planner promised 15-18 percent annual interest returns on high-yield investments that were never made.

- A Vancouver, Washington, financial planner was arrested on March 29, 1988 in Fairbanks, Alaska, after fleeing Washington state and hiding out for a year in Saipan to avoid facing securities charges brought by the Securities Division of the Washington Department of Licensing Business & Professions Administration. The promoter is believed to have lured 400 investors into parting with $7 million that went to a shell off-shore bank in the Marshall Islands. The promoter promised 30-40 percent returns in the fake bank's CDs, precious metals and international "arbitrage trading" program. An investigation determined that the only bank "officer" was a Marshall Islands gas station owner who went to a local post office box and remailed investor checks to the financial planner's office in Washington state. Three months before initiating the bank scam, the Vancouver man had been ordered by the state to suspend the operations of his accounting and tax preparation firm, which had been implicated in a number of suspect investment deals.

- In the largest fraud case ever brought against a financial planning firm in the U.S., New York Attorney General Robert Abrams filed charges on November 5, 1986 against an Albany firm that recruited more than $55 million in investments from 950 Northeast residents. The firm failed to disclose that its salesmen were earning hefty commissions on the grossly overvalued coins, art and Florida condos in which investor funds were placed. The promoter, who neglected to notify investors that he had been convicted on a felony gambling charge, presented himself as a financial expert even though his background was limited to a high school diploma and brief stints as an insurance salesman and supervisor of a Massachusetts Thruway toll station.

A Closer Look at Investor Losses

The almost $400 million in aggregate investor losses involved in major 1986-88 state actions against financial planners was up sharply from the $91 million in aggregate investor losses reported in the 1985 NASAA Survey. These figures correspond closely to the $125 million in lost investor funds reported in

the Consumer Federation of America's 1987 survey of enforcement actions undertaken by state securities agencies. The CFA financial planner study noted: "We believe that this figure represents, at most, one-half the dollar value actually involved in fraud and abuse in those states, and that losses in those states probably represent approximately a third of the national total ..." Using a slight variation on this formula, the total national losses which could be projected from the 1988 NASAA Survey would be in excess of $1 billion for the two years under review or $500 million or more a year.[7]

Whether the appropriate figure for investor losses arising from financial planner fraud and abuse is $1 billion or the more conservative $400 million, it would account for a relatively small portion of the total investment dollars under management by financial planners. However, this "macro" approach to analyzing the impact of bogus financial planners ignores the very real human terms associated with even relatively modest swindles. For example, the 70-year-old San Antonio area woman who lost her entire life savings in an $8.3 million home loan scheme and was forced to go back to work in order to make ends meet would not be consoled. Nor would the "big picture" provide much comfort to the hundreds of Americans who each year become enmeshed in financial planning fiascos and lose homes or end up owing thousands of dollars in deductions, penalties and interest to the Internal Revenue Service.

The Surge in Financial Planning Fraud

A comparison of the 1985 and 1988 NASAA surveys of financial planner fraud and abuse indicates that the number of state actions against financial planners rose 155 percent and the amount of lost investor funds climbed 340 percent. The 79 cases included in the 1988 NASAA Survey marked a steep rise from the 31 in the 1985 report. While only one of the 1985 NASAA Survey cases topped $20 million in investor losses, five major actions scattered across the nation in New York, Illinois, Missouri, Washington state and Oregon involving aggregate investor losses of more than $30 million each were uncovered in the 1988 NASAA Survey.[8] The five state investigations accounted for only

[7] Interestingly, CFA projected total investor losses due to financial planner fraud and abuse at $540 million a year.

[8] These cases are: $55 million in New York State in a financial planning firm promoting overvalued coins, art and Florida real estate investments; $45 million in Illinois involving a financial planner who placed Chicago area investors in trusts and real estate limited partnerships; $30 million in Missouri in a commodities scheme involving deferred delivery of

Table II
Scale of Investor Losses (1988 NASAA Survey)

Investor Losses	No. of Cases
Under $500,000	29
$500,000 - $999,999	9
$1 million - $4,999,999	22
$5 million - $9,999,999	10
$10 million - $19,999,999	4
$20 million - $49,999,999	3
Over $50 million	2
	79

6.3 percent of all reported cases, but added up to $218 million of all lost investor funds -- 55 percent of the total amount. This evidence suggests a major trend in the direction of "big ticket" financial planning swindles in all corners of the nation.

Also evident in the 1988 NASAA Survey is a rapid acceleration in the rate of the filing of state actions against financial planners. More than half of the 79 cases filed during the past two years were concentrated in the first seven months of 1988. The first year (mid-1986 to mid-1987) accounted for a total of 23 cases or just 29 percent of the total number of actions undertaken during the entire survey period. The second year (mid-1987 to mid-1988) saw a 140 percent jump to 56 cases. The pace now seems to be quickening even more, with 43 investigations -- or 54.4 percent of the two year total -- having been settled or opened in the first half of 1988.

Criminal Prosecution of Financial Planners

State securities agencies are taking a hard-nosed approach to crimes committed by financial planners, according to the 1988 NASAA Survey findings. A total of 300 years of prison sentences were imposed in 13 cases, including the 222 year sentence of a Virginia financial planner who embezzled $1.3 million from 40 investors in eight states. Criminal prosecution was either

platinum bars from South Africa; $56 million in Washington state in a massive "debenture bank" program used by a financial planner to make undisclosed loans to his own enterprises; and $32 million in Oregon in a giant real estate network supposedly secured by first and second trust deeds and promissory notes.

underway or planned in another 20 of the state cases. The 33 financial planner fraud cases involving criminal prosecution accounted for 42 percent of the major state actions included in 1988 NASAA Survey. This rates as an extremely high level of criminal referral for white collar crime cases.

State- or court-ordered restitution was another major tool that state securities agencies employed to punish fraudulent and abusive financial planners. In six cases (7.6 percent of the total number), the return to investors of a total of $3 million was required.[9] Additionally, more than $250,000 in administrative fines and penalties were imposed on financial planners in three other cases.

[9] In one unreported Idaho case, a financial planning firm was ordered by the state to return $26 million to investors in an unregistered securities case. The state moved quickly enough that no investor losses were sustained before the rescission action was taken.

REGULATION OF THE FINANCIAL PLANNING INDUSTRY

A growing number of states are taking up the challenge of regulating the conduct of financial planners. The impetus for the new state action came in 1986 and 1987 in the form of model investment adviser laws and regulations promulgated by NASAA. The rapid growth of the financial planning industry has led to a highly coordinated state-federal approach to investor protection. Joint enforcement actions, audits and training are carried out on a regular basis. However, the absence of even the most minimal qualification standards for registration with the SEC as an investment adviser (IA) means that almost anyone will continue to be able to print up business cards reading: "Registered SEC Investment Adviser." The 1988 NASAA Survey turned up more than half a dozen major fraud cases involving financial planners who were registered as IAs with the SEC.

The Traditional Federal Role

Federal regulation of investment advisers is based on the Investment Advisers Act of 1940, which, in theory, requires almost all IAs, including financial planners, to register with the SEC. In practice, the IA registration process is only slightly more complicated than the steps involved in getting a Social Security number. A registrant simply pays a $150 fee, fills out a few forms and then waits 45 days for the documents to be processed. A registration can be denied if the Commission finds the adviser has committed certain prohibited acts, but the rejection rate is extremely low.

A central element of federal IA regulation is the requirement that all registered IAs must furnish each advisory client with a written disclosure statement. This "brochure rule" is intended to provide consumers with the information needed to evaluate the adviser's qualifications, investment methods and and potential areas of conflict-of-interest. However, the 1987 ICFP survey found that only 27 percent of clients recalled receiving a disclosure document from their financial planner. The SEC has reported that while 85 percent of planners sell products to clients and, as a result, earn commissions, this potential conflict of interest is only disclosed by 45 percent of the planners. Clearly, there is hardly universal compliance with the SEC investment advisor disclosure rules.

The States Get Tough

One new prospect for improved regulation of financial planners is the NASAA model investment advisor law and regulations, which were approved by the Association's membership in 1986 and 1987. The NASAA model developed for use in individual states answers the "who must register?" question by going beyond the SEC-style registration of IA firms, to the individual representatives who deal directly with customers. The theory here is that while firms rarely defraud individuals, individual financial planners do. Under the NASAA model, all financial planners who engage in investment advisory services must register with the state as investment advisers.

The NASAA model for investment adviser regulation imposes specific standards in the following areas:

- Net capital rules;
- Recordkeeping requirements;
- Testing of investment advisers and their representatives;
- Written disclosure to clients regarding such issues as the qualification of the investment adviser, conflicts of interests, services offered and fees charged; and
- A detailed code of ethics for investment advisers.

What is proposed in the NASAA model is nothing less than a shift from perfunctory oversight of investment advisers to a regulatory system that more closely resembles the more extensive oversight that presently exists for brokers. Currently, the majority of state securities agencies have jurisdiction over investment advisers, many of whom provide financial planning services to their clients. Forty states currently provide for the registration and regulation of those who fall within the investment adviser definition.[10] However, most of these "first generation" state laws are patterned on the federal IA Act of 1940 and share most of the same limitations. These shortcomings are offset somewhat in 21 states that require that individual

[10] States that require the registration of investment advisers: Alaska, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wisconsin.

IAs, and not just firms, to register with the state.[11] Of the 11 jurisdictions that do not currently require the registration of IAs, five are considering such legislation.[12]

[11] States that require registration of investment adviser representatives include: Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Kansas, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Utah, Virginia, Washington and Wisconsin.

[12] States where investment adviser regulation is under consideration include: Alabama, D.C., Maryland, Massachusetts and Ohio.

CONSUMER ALERT: Avoiding Financial Planner Fraud

While there are many honest, skilled people doing excellent work today as financial planners, it is apparent from state enforcement actions that the largely unscrutinized financial planning industry provides excellent "deep cover" for a substantial number of swindlers, con artists and abusive and unethical promoters. And even in the legitimate industry, the term "financial planner" sometimes simply serves as a euphemism that agents and brokers use to help them sell the products they've always sold. An informed investor can take steps to reduce the odds of ending up disappointed in his or her dealings with a financial planner. What follows are a collection of investor "survival tips" spelling out how to deal with investment advisers.

Background: The Basics of Financial Planning

The key to understanding how the financial planning industry really works is to remember this: Few financial planners simply plan. As Consumer Reports magazine has explained it, "... planning itself may be a service but it almost inevitably leads to the purchase of financial products. Many planners turn out to have hidden agendas that become evident when planners form recommendations. That's when the planners are likely to regress into the roles that may have been their sole occupation before they became financial planners." There are three major categories of financial planners:

- Fee Only/Salaried
  This is the rarest of all financial planners: The investment adviser who either is salaried or charges a certain amount to draw up a financial plan but does not have products of his or her own to promote, such as stocks or real estate partnerships. These planners charge either an annual fee based on assets and investment activity or an hourly fee of $50-$200 or more. The advantage here is that the planner does nothing more than give advice and is free of conflict-of-interest concerns related to commissions earned on investment products. A CFA study of 30 financial planners in the Washington, D.C. area found that only one of those surveyed was paid a flat salary and just two others were fee-only planners.

- Fee/Commission
  Almost nine out of 10 financial planners get at least some of their income from commissions earned on the products used

to implement the plans drawn up for their clients, according to a February 1988 SEC study. A 1985 IAFP survey found that, on average, 64 percent of a planner's gross revenue are derived from commissions. While this arrangement generally reduces the direct cost of a financial planner to an investor, there are obvious conflict-of-interest risks inherent in the considerable temptation the planner faces: Do I give the client the products he or she really needs? Or, do I implement the plans that will pay the biggest commissions to me? The CFA found in its study that the products urged on investors "almost always reflected the primary business of the company designing the plan."

- Commission
  Some financial planners charge their clients no fee at all, but do get commissions on the investment products they sell. The argument made on behalf of these planners is that since a financial plan requires investments, the customer benefits from the convenience of "one-stop shopping" and would, in any event, have to pay a commission no matter where the product is purchased. The argument ignores the strong possibility that the particular products that are recommended may not be the most competitively priced or highly performing in the marketplace, when a planner's commission is a key considaration.

Profiles in Financial Planner Fraud

Certain basic "characters" emerge in the 79 major enforcement actions included in the 1988 NASAA Survey of financial planner fraud and abuse. Here are some tips on spotting the potentially fraudulent or abusive financial planner:

- Unqualified Planners
  A competent financial planner must have a firm grasp on the intricacies of finance and tax law. However, the SEC reported recently that "the information that exists suggests that many planners, perhaps even a majority, are fairly new to the planning business." Many planners, in fact, have less investment experience than the clients on whose behalf they act. However, a somewhat inexperienced, but sincere, financial planner poses far less of a risk to an investor than one who is flatly unqualified or incompetent. The 1988 NASAA Survey found several cases of ex-preachers, savings and loan officers, income tax preparers and others with extremely limited backgrounds who posed as financial wizards with "can't lose" formulas for investment riches. The key promoter in a $55 million financial planner fraud case in New York state had one of the most limited backgrounds: a high school diploma and brief working histories as an

insurance agent and supervisor for a Massachusetts Thruway toll station.

- "Product-driven" Planners
The lure of fat commissions can throw a monkeywrench into the relationship between almost any financial planner and client. SEC inspections of financial planning firms indicate that employees devote more time to product sales than actual financial planning. Aside from straight commissions, there is other "bait" for planners. For example, investment companies who attend financial planner trade shows have been known to give financial planners a little extra push to generate sales. In the case of one mutual fund, the salesman who logged the highest total sales by year end was promised a choice of a Porsche 944 Turbo, a Jaguar XJ-S or a Corvette. In this type of an arrangement, it seems clear that it is not the investor who will be in the driver's seat of his or her financial plan.

- The Planner With a Past
Recent state enforcement actions reveal that unscrupulous financial planners frequently fail to mention to investors relevant events out of their past, including bankruptcy proceedings, previous run-ins with state securities agencies, felony convictions, outstanding court judgments and so on. The New Jersey Bureau of Securities refused in February 1987 to transfer the registration of a Fairfield, N.J., man who had failed to tell clients that he had just four months before signed an agreement with an Atlanta woman from whom he had taken $35,000 in IRA funds. In a restitution agreement signed with the woman and her lawyer, the financial planner acknowledged that he was "a compulsive gambler" who had wagered away the woman's investment. The financial planner also failed to disclose that he had filed for personal bankruptcy in 1979. In another state case, a routine audit conducted by the Securities Division of the Indiana Secretary of State led to the discovery that an Indianapolis financial planning firm was attempting to hide from investors the involvement of a promoter who had been convicted for the promotion of bogus tax shelters.

- The "Moonlighter"
The "moonlighter" sets up an outside investment adviser business, while all the time maintaining his relationship with an established brokerage, insurance or realty firm. This arrangement allows the financial planner to: (1) escape day-to-day oversight by supervisors; (2) attract investors with talk of having "an inside track" with an established firm; and (3) have access to sensitive financial information in order to pick and choose among potential victims, particularly in the case of clients of brokerage firms and financial institutions. In Tennessee, a registered broker

opened a separate office and promised 16-40 percent annual returns in real estate deals, short-term notes and other investment programs. More than 40 trusting investors placed about $1.2 million with the financial planner. The Tennessee Securities Division's investigation found that the man had diverted investor funds into rental of a private plane, luxury autos, a condominium and fine jewelry.

- The Ponzi Schemer
Spotting an out-and-out con artist posing as a financial planner requires a setting aside of greed and the realization of the truth in the old maxim "if it sounds too good to be true, it is." Remember that con artists whose sole intention it is to bleed investors dry do not have to bother with the details, so their swindles, many of which are thinly-disguished Ponzi schemes, frequently take on fantastical airs. Five common warning signs of a fraudulent financial planner are: (1) promises of unrealistically high, above-market rates of return, such as 20 or 40 percent annually; (2) an indication that the investment is "guaranteed" and cannot result in loss of investor funds; (3) statements to the effect that the investment strategy is too complex to be understood and that total faith in the promoter is a must; (4) an unclear or entirely unstated investment purpose, such as a blind pool for investing in the stock market at the planner's discretion; and (5) an exotic element in the sales pitch, such as the involvement of an off-shore bank, new top-secret technology or inside information from Wall Street titans. Another "red flag" common to many fraudulent financial planners: Many "fly solo" and operate tiny offices, with little more than room for an answering machine. It is very easy for a "footloose" financial planner who is operating little more than a mail drop to pick up and move quickly.

The Key Questions to Ask a Financial Planner

1. What is your professional background?
Look for a strong track record of education and job experience covering the bases of financial planning. Make sure that your planner takes advantage of continuing education and training to keep current in his knowledge of the fast-changing investment world. Ask to see a copy of the SEC-required written disclosure statement.

2. How long have you been a financial planner?
Look for an adviser who has some experience under his belt. A good rule of thumb is that the planner should have logged five or more years of previous experience as a broker, insurance agent, accountant or lawyer. Look for someone who

has logged another three or more years as a financial planner.

3. **How long have you been in the community?**
One of the basic rules of investing applies here: Deal with those individuals you either know personally or can check out through reliable references with trusted friends, business colleagues, bankers or other professional.

4. **Will you provide references from three or more clients you have counseled for at least two years?**
Check out the track records of individual clients who use the planner. Get the names of several long-term clients and ask them about their level of satisfaction, returns, and intentions about staying with the financial planner. Avoid financial planners who pressure you to rely on the word of one or two new clients, who unwittingly or otherwise may be "songbirds" primed by the promoter to sing his praises. The danger here is that a planner with a Ponzi scheme may line you up with one of the handful of early investors who were paid off in order to lure new investors like yourself.

5. **May I see examples of plans and monitoring reports you have drawn up for other investors?**
Pay particular attention to the frequency and quality of the monitoring reports, since these updates will be vital to recharting your financial objectives.

6. **How will you make your money on my plan?**
Be blunt and ask the financial planner how he or she stands to profit from dealing with you. Determine if the planner earns fees, commission income or some combination of the two. If there is a heavy degree of reliance on commission income, keep this fact in mind when the planner recommends that you purchase specific investment products.

7. **Do you have a background of court or administrative actions involving personal bankruptcy, tax problems, professional license revocation or securities violations?**
It doesn't hurt to ask. You may not get a straight answer, but you can get a basic reading on the financial planner by contacting your state securities office, which will report on the details of any enforcement files related to the adviser. The 1988 NASAA Survey turned up a number of cases where a check of the backgrounds of fraudulent promoters would have revealed previous problems with securities laws. To get the number of your state securities office, contact the toll-free NASAA Investor Hotline, 800/942-9022.

The Minimum Services A Financial Planner Should Provide

No matter what type of financial planner you decide to do business with, you should get at least the following basic services for your money:

- A clearly written and individualized financial plan, including a balance sheet of assets versus liabilities, and a projected cash flow statement for at least one year. This plan should include a precise definition of your financial objectives and the steps you will take to achieve them.
- A discussion of the amount of risk you are willing to assume in order to achieve your financial goals.
- Specific suggestions for improving your personal cash management.
- A detailed explanation of the assumptions underlying the financial plan, including projections for shifts in the rates of inflation and interest.
- A range of investment choices, with the pros and cons defined for each course of action. You should be provided with alternatives, rather than a short list of one or two high-commission products selected for you by the planner.
- Additional advice, if needed, from other professionals, including lawyers, accountants and stockbrokers. This is particularly important if you do not already have established contacts with professionals in these areas.
- A specific schedule for monitoring the progress of your financial plan, including periodic opportunities for reviewing your objectives and checking on the performance of your planner's advice.

DETAILS OF THE 1988 NASAA SURVEY

ALABAMA

- A Marietta, Ga., man was sentenced on February 19, 1988 to five years in a federal prison for a "consumer savings certificate" scheme that involved $226,000, including $181,000 in losses sustained by 16 Alabama investors. A former pastor of a Baptist church in Mobile, Ala., the promoter offered "Christian financial planning" in which churches and their congregations were targeted for the sale of phony high-yield investments that were supposed to bear 15-18 percent annual interest rates.

- A Huntsville man is now serving a 10-year prison sentence for a financial planning scheme in which he took an estimated $18 million from 193 investors, most of them residents of the Huntsville area and members of a particular church. The promoter told investors that he was pooling their funds to invest in stocks and promised returns of 8-30 percent a month. A former accountant, bookkeeper and bank trust officer, the self-proclaimed financial planner also traded on his role as the treasurer of the largest Baptist church in the state. One victim stated: "It was sort of comforting to see the Bible verses printed at the end of monthly statements." A court action initiated by the Alabama Securities Commission found that the $18 million had been scattered over 40 bank accounts in seven banks. In Alabama's largest single fraud case, the Huntsville man pled guilty in September 23, 1987 to two felony counts, was fined $30,000 and sentenced to two 10-year prison stints to be served concurrently.

- A Dothan tax preparer was sentenced to 15 years in prison in 1986 for fraudulent financial planning activities that involved $1 million taken from 19 victims, including a number of elderly widows. The promoters claimed to be placing investors in 12 different investment programs, including tax shelters, insurance, mutual funds, office machine leasing and the rebuilding of a hydroelectric dam. A state inspection found that most of the programs were nonexistent.

- An Enterprise man was sentenced to five years in prison in 1986 when he took $62,000 from a local woman after promising to use the proceeds to purchase a U.S. Treasury Bond with a face value of $100,000. Instead, the funds were converted to the personal use of the promoter.

ARIZONA

- The Securities Division of the Arizona Corporation Commission in February 1987 ordered $135,000 in restitution to 30 investors who had placed an estimated $200,000 with a Phoenix financial planning firm that promised a return of 10-40% over periods ranging from three months to a year on "promissory notes/assignments." The two promoters in the scheme maintained a telephone "boiler room" operation and offered to refinance home mortgages at an extremely low interest rate. In a classic "bait and switch," the telephone sales pitches quickly shifted to financial planning services. The unregistered notes were promoted to investors as safe and liquid. The pair failed to disclose to investors that their financial planning firm had filed a bankruptcy petition in June of 1985.

- The state securities division moved in September 1986 to shut down a Phoenix firm that was issuing promissory notes for general investment purposes that led to 31 investors losing $535,000. In a complicated scheme, the promoters failed to disclose to investors that a major portion of the funds were diverted to buy stock in a defunct firm that was merged into a Utah shell corporation.

ARKANSAS

- A Fayetteville man, who is now a fugitive, pooled an estimated $6 million in funds from more than 300 investors in 20 states for investments in the stock market. The financial planner sold $1,000 shares in an investment club that was supposed to invest in various mutual funds. Some investors also were told that their proceeds were being used to invest in a Jacksonville, Fla., "gray market" importer of European automobiles and a frozen yogurt franchise chain. After an investigation by the Arkansas Securities Department started in April 1987, the promoter attempted to reassure investors with a letter stating that one of the major investment programs involved had total assets of over $5 million, including $3.46 million in cash. The state investigation subsequently found that the only known bank account for the program at the time the letter was written contained just $3,362.54 at the time the letter was written. On June 29, 1987, the promoter sent a second letter to investors promising a dollar-for-dollar "buyout" of all investment interests by an unnamed Texas firm. Shortly afterwards, the Fayetteville man disappeared. He remains a fugitive to this day.

CALIFORNIA

- A complaint was filed on January 7, 1988 by the California Department of Corporations against a financial planner in Covina who raised more than $6 million from 2,000 investors, many of whom were recruited through investment seminars. The Covina man claimed to be placing the investor funds in 100 different limited partnership programs, including real estate syndicates, wind energy tax shelters, blind mortgage loan pools and jojoba bean marketing programs. Seminar attendees were encouraged to borrow against the equity in their homes. More than half a dozen of the limited partnerships were found by the state to be phony and consisted of nothing more than a mail drop for investor checks.

- Civil suits are now pending against a Los Angeles area financial planner, who catered to physicians and specialized in the establishment of retirement plans and educational trusts for children. At least 38 investors lost a minimum of $4.5 million in the planner's "defined benefit pension plan" schemes in which funds were supposedly invested in bank-issued "matching fund" certificates of deposit (CDs). Individual investor losses ranged from $55,000 to $700,000. The promoter advertised himself as a crusader "fighting" for the financial health of Southern California doctors. A state investigation found investor funds had been siphoned off into four homes, including a mansion in Los Angeles, a Palm Springs desert retreat and a half-share in a Maui condo. The promoter also used the proceeds to purchase a 33-foot yacht, antiques, furs and a Rolls Royce. One victim stated: "I think I know now what it feels like for a woman to be raped, because I've been raped emotionally and financially by [the financial planner]."

- A Newport Beach financial planner disappeared from his office and cleaned out his bank accounts shortly before the California Department of Corporations went to court on January 29, 1988 to seek an temporary restraining order and appointment of a receiver. Losses of $2 million were reported on behalf of 50 investors who had been placed between 1982 and 1987 in limited partnerships in rental property, commercial buildings and mobile home parks. More than 100 of the properties, which were worth only a fraction of the values claimed by the Newport Beach man, are now in foreclosure proceedings. The whereabouts of the financial planner remain unknown.

- A November 7, 1986 state administrative order shut down a Bonita financial planner who used investment advice seminars in the San Diego area to identify participants for his oil and gas and "securities and commodities arbitrage agreement"

investment programs, which were supposed to be guaranteed with promissory notes returning 24-36 percent annual interest, at the pay-out rate of 2-3 percent a month. At least 21 investors received no return the $241,000 they had invested. The Bonita man had dabbled in the past as an insurance and securities salesman.

COLORADO

- A Colorado Springs brother and sister financial planning team were accused in a June 15, 1988 criminal indictment of a pattern of fraud involving $1.9 million from 144 investors, including 122 state residents. The Colorado Division of Securities had moved in July 16, 1986 to freeze the assets of the pair's financial planning chain, which maintained offices in five Colorado cities. The promoters, who advertised to consumers a total of 130 services ranging from auto insurance to off-shore trusts, claimed to be placing investor funds in Individual Retirement Accounts (IRAs), money market funds, deferred currency purchase agreements, bridge loans and various promissory notes. The state investigation revealed that the Colorado Springs financial planners were operating a Ponzi scheme with total liabilities of at least $1.2 million. Funds had been diverted into exorbitant salaries, the purchase of a private home and 15 automobiles, including a number of classics. A Colorado court held one of the promoters in contempt on July 31, 1987 and imposed a fine of $8,000 and a 30-day jail sentence. The financial planner posted an appeal bond and fled to Texas, where he operated an advance fee loan scheme. Under this illegal pyramid scheme, investors, who paid $337.95 to sign up and an additional $25 per month, were to receive $100,000 in annual income after recruiting a large number of other "loan applicants."

- An Arvada financial planner was ordered on June 16, 1988 to spend 120 days in a county jail for promoting a "self-liquidating loan" investment scheme in violation of a May 1985 court order barring him from the sale of unregistered securities. The promoter circulated a large number of letters asking prospective investors: "Would you be interested in a business loan that you never had to repay either principal or interest out of your own pocket because it was (a) self-liquidating loan and paid itself?" Promising to make investors millionaires for as little as $100, the deal was supposed to work like this: For a loan application fee ranging from $100-$450, an investor could borrow up to $10 million from an unnamed California corporation on a five year term at 2 1/2 percent below the

prime rate. Of the loan proceeds, $7.1 million would be used to buy government securities with a face value of $10 million, another $500,000 would go into zero coupon bonds and money market funds, $1 million would go to the promoter for "lender's management" fees, and $1 million to the investor. No matter whether the loan deal worked out or not, it was required that 7 percent of the investor's prospective $1 million cut -- or $70,000 -- be lent to the promoter. How was all of this supposed to add up to a "free" $1 million? The interest income generated by the government securities, bonds and money market funds were to be used both as collateral to secure the loan and the source of income for the 70 monthly payments, hence the term "self-liquidating" loan. Also in violation of the 1985 court agreement, the Arvada man promoted a $49-a-head pyramid scheme that supposedly offered the side benefits of financial planning for life and prepaid legal services. Under an earlier suit brought by the Colorado Division of Securities, the Arvada man was ordered on May 17, 1985 was ordered to make $87,000 in restitution to 80 investors who had invested in real estate general partnerships and irrevocable letters of credit. It was estimated that total losses in the financial planning scam were $1.6 million. Almost two years after the state action was complete, the Securities and Exchange Commission (SEC) revoked the planner's Investment Advisor registration on February 6, 1987, which was not long before the planner faced unrelated charges for attempting to bilk a long-distance telephone company out of more than $766,000.

CONNECTICUT

- State investors lost at least $144,000 in an elaborate financial planning scheme which was operated through four related firms in Mill Valley, Calif. Estimates of losses nationwide start at $3-5 million. One of the California firms recruited "financial planners" in more than 20 states to offer and implement plans, primarily in business opportunities involving pay telephones and solar-powered water heating units. The Investment Division of the Connecticut Department of Banking Securities and Business shut down the activities of the financial planners in the state on November 13, 1987. The financial planners operated under strict orders to put all investors in a small number of high-commission products, which also included limited partnerships and mutual funds with an advisory timing service. Undisclosed to investors were the following facts about the chief promoter: (1) that he had entered into an agreement with the pay telephone firm guaranteeing to recruit enough financial planners and investors to generate

$10 million a year in investments; (2) that he had been imprisoned in 1976 as a result of a fraudulent business opportunity scheme involving $9.2 million in investments in railroad cars; and (3) that, after the 1981 diamond market collapse, he had entered into a $6.7 million settlement agreement with the Federal Trade Commission (FTC) in an "investment grade diamond" program that also was promoted to the public through the use of financial planners.

FLORIDA

- A former Coral Gables woman faced a 21-count indictment on January 20, 1988 in San Francisco for bilking 17 Southern Florida residents out of more than $290,000 in various oil and gas and real estate deals. The financial planner, who had been named "Outstanding Business Woman of Dade County" and a "financial fairy godmother" by Florida Trend magazine in 1982, placed investors in limited partnerships in oil and gas wells that never broke ground in Ohio. Other losses were sustained in avocado groves in Dade County and a New Hampshire country club and inn. The promoter, who had since moved to Novato, Calif., claimed that the investments were guaranteed by promissory notes.

- The Securities Division of the state Office of the Comptroller filed civil and criminal charges March 10, 1987 against two Palm Beach financial planners who recruited elderly victims through investment seminars held under the auspices of a "Jolly Sixties Club" affiliated with a church in West Palm Beach. Starting in June 1986, the pair convinced 21 investors to place nearly $400,000 in promissory notes said to be secured by corporate assets and mortgages. Annual rates of return of 12, 15 and 18 percent and more were quoted to various investors. The funds supposedly were to be invested in firms owned by the promoters, which turned out to be thinly capitalized, with no real assets. Instead, the promoters diverted the funds to personal uses, including $13,000 for the construction of a swimming pool and $36,000 for home improvements. At the time of the state action, Comptroller Gerald Lewis said: "People could have called the Comptroller's Hotline and learned that their securities and the dealers are not registered with the state."

GEORGIA

- A Georgia broker "moonlighted" as a financial planner in order to convince at least seven investors to sell their

$290,000 worth of mutual fund shares and reinvest with him in other products, primarily real estate estate developments. The Division of Business Services and Regulations of the Secretary of State found that the broker/financial planner used the detailed information available about his brokerage clients to target the most likely victims. A warrant was issued on March 2, 1988 for the broker on charges of theft by deception, but the man vanished and is now believed to be somewhere in Texas.

- A Marrietta man was arrested by U.S. Marshals in New York City on January 13, 1988 to answer to an August 1987 indictment on charges of securities fraud in Georgia. The financial planner was accused of taking at least $174,000 from several elderly investors, including a 65-year-old retired truck driver who lost every dime of his $47,000 life savings and was left with no retirement income. The financial planner operated his business out of a tax preparation service firm, which provided a steady stream of potential investors. The man freely confessed to investigators that he was a "dope dealer," but not a drug user. Sometime between his July 1987 indictment on narcotics charges and his securities fraud indictment in August, the man fled to the Massachusetts, then Connecticut and, finally, New York City. He was arrested shortly before he planned to move to France. Criminal proceedings against the Marrietta financial planner are now proceeding.

- A receiver was appointed in 1986 to untangle the complex dealings of an Atlanta man who operated as a financial planner in order to line up $3.8 million for a phony investment pool. It has not been established that a single dollar of the money ended up in any actual investment. Investor funds were traced to 25 separate bank accounts, but recovery appears unlikely since no records were kept of the financial planner's dealings. The court-appointed receiver found some evidence that investor dollars may have been spirited away to Caribbean and European banks.

IDAHO

- A former Boise man was ordered by the Idaho Securities Bureau on October 13, 1987 to make full restitution to two investors for $500,000 in losses. The financial planner convinced the investors to allow him to serve their investment portfolio manager and then moved the funds to his personal account. The planner lost all but $30,000 in a series of exotic investment strategies.

- Three Spokane men and the fictitious "Western International Bank of Nuku Alofa, Tonga" were linked by the state in an August 24, 1987 civil suit to $250,000 in losses sustained by 13 investors. Investors were told that stocks and CDs purchased through the nonexistent foreign bank could bring annual returns of up to 35 percent. In an appeal to regional interests, the financial planners also solicited investments in limited partnerships and self-insured programs that supposedly were to benefit workers in the timber and logging industry.

- A realtor turned financial planner from Ontario, Oregon, was taken to court by the state on October 10, 1986 to face charges of fleecing 75 investors of $2 million, including $440,000 lost by 25 state residents. The financial planner falsely claimed that his personal and corporate notes bearing 18 percent annual interest were secured by trust deeds. At the time of the Idaho court proceeding, the promoter already was in jail in Vale, Oregon, on related charges.

- A Nampa man who worked for an insurance firm and was licensed to sell insurance and securities posed between August 1985 and July 1986 as a financial planner offering "special" high-yield mutual funds. When asked to provide account statements for the mutual funds, the Nampa man blamed the delays on insurance company computer problems and a recent office move. The financial planner convinced five investors to write out checks to him for $60,000, rather than to the insurance company through which the mutual funds would have been purchased. The financial planner was ordered in 1987 by the Idaho Securities Bureau to make full restitution to the investors involved.

ILLINOIS

- More than 6,000 Chicago area investors have lost $45 million to a financial planner in Barrington, according to an ongoing investigation by the Securities Department of the Secretary of State. A receiver was appointed on July 15, 1988 to handle the few assets of the firm and the promoter, who claimed to be placing investor funds in trusts and more than 350 separate real estate limited partnerships. The services of the financial planner were at first promoted heavily on Chicago radio and television stations, but were later targeted to people near retirement age. The prospective investors were provided with a four-night, eight-hour financial planning course followed by a personal session with the promoter. The near-retirees were told that they would earn more money after retiring than they were

making while working. To date, the investigation has determined that investor funds went for the purchase of three homes, including two in Hot Springs, Ark., a 26-foot boat, aircraft, an airport hangar and motor vehicles. The financial planner failed to disclose to investors that he had been the subject of a state administrative action in 1983.

- "Investment grade biblical antiquities" and "passbook accounts" in gold and silver were the unusual opportunities promoted by an Itasca financial planner who inflicted $8 million in losses on more than 400 victims in 19 states. The promoter claimed the passbook accounts in precious metals were protected by $5 million in assets when, in fact, none existed. The state's investigation of this Ponzi scheme continues.

INDIANA

- A criminal trial is set for September 1988 for a Columbus, Ind., investment advisor who pooled the funds of more than 61 investors and then lost in excess of $300,000 in options trading. Few of the investors were suitable candidates for trading in options. In loan agreements with investors, the financial planner promised as high as 15 percent quarterly returns. The matter is now the subject of a bankruptcy proceeding and a number of investor lawsuits.

- The Securities Division of the Secretary of State filed a complaint on July 13, 1988 against an Indianapolis financial planning firm that attempted to hide the key role of a promoter who was convicted on December 11, 1987 for sale of bogus tax shelters. A state audit of the firm found that 48 percent of 1987 financial planning fee income went to the "silent partner," whose role and criminal activities were not acknowledged in the firm's federal ADV filing. The firm also failed to disclose the background of the promoter to investors, who are believed to have last an estimated $300,000. The state securities investigation into this matter is continuing.

- A financial planner, who also is a certified public accountant, was sentenced in 1987 to serve two years in prison for selling $6 million in unregistered and abusive investments in precious metals to his tax and accounting customers. The investments were "secured" with promissory notes from the promoter, who had offices in Indianapolis and Anderson.

- An Indianapolis financial planner, who concentrated much of his promotional efforts on Black servicemen, has been linked to at least $25,000 in investor losses in vaguely defined contracts promising a tax-free 10 percent return every six months. Most of the contacts with investors were established through the Indianapolis man's insurance office. Sales also were made at Fort Benjamin Harrison, an Indianapolis Army post, and a booth at the meeting of a Black organization.

MAINE

- A Boston financial planner was ordered in March 1987 by the Securities Division of the Maine Department of Professional and Financial Regulation to stop soliciting investors in the state. At least 200 Maine victims lost $2 million in two real estate and property programs involving time-share condominiums in South Carolina and "income producing" properties in Maine and Massachusetts. Substantial amounts also were believed to have been lost by investors outside of Maine, particularly in the Boston area. The financial planner, who also operated a small Maine office in Portland, was accused of commingling funds, and lost at least $60,000 of the investor proceeds in the stock market. In 1987, the Boston man consented to make restitution, but then entered bankruptcy proceedings which blocked the return of funds to investors.

MARYLAND

- More than $1 million was lost by 70 investors in "jumbo CDs" and limited partnerships promoted by a Towson financial planner, who was ordered by a court on May 4, 1988 to turn over all assets to a court-appointed receiver. An investigation by the Division of Securities of the Attorney General found that a retired steel company executive had been convinced to place his entire $160,000 lump-sum retirement distribution into oil and gas and real estate partnerships, which were promoted as safe and bearing extremely high interest rates. Other investors were recruited to pool money into what were described as "jumbo CDs" of $100,000 or more. The financial planner claimed that an unspecified federally-insured institution was offering the CDs at 3-4 percent over prevailing interest rates. Instead, state securities regulators found that the promoter put the funds in his personal checkbook and other "slush funds" and, according to one source, spent

substantial amounts on gambling and vacations in South America and Europe.

- A father and son team in Randallstown offering both financial planning and brokerage serves have been linked to over 40 investor complaints totaling to more than $1 million. Most of the suits came in the wake of a 1986 state order that the father/financial planner make restitution of $7,870 to a couple. The father used his business as a tax preparer to identify older couples with retirement nest eggs of $85,000-$100,000 and offered to provide financial planning, which invariably involved high-commission coin sales and the establishment of a discretionary trading account at a small brokerage firm operated by the promoter's son. Though most of the investors' sophistication in matters of finance was limited to dealing with banks and savings and loans, the son/broker appeared to have churned the accounts and engaged in extensive trading and short selling. One woman, for example, found that her investment was turned over eight times in one year with the son/broker. The financial planner failed to disclose to investors that he had been the subject of a December 1984 consent order with the IRS involving abusive tax shelters in master recordings. A large number of investors in the bogus tax shelters filed 310 improper credits and declarations resulting in back taxes, penalties and interest of $7.7 million, according to the IRS. In order to block investor lawsuits filed in 1987 and 1988, the financial planner initiated bankruptcy proceedings. A Dundalk woman, who lost $69,000 of her initial $120,000 investment, stated: "[The broker] came to our home and ate at our table and told us that we would be alright because we were in safe investments. He lied to us."

MASSACHUSETTS

- A Cambridge financial planner offered his investors an incentive to line up other victims in a real estate investment pool that resulted in losses of $450,000. The Securities Division of the Secretary of the Commonwealth filed a temporary cease and desist order on February 24, 1988 against the financial planner who offered 20 percent or more annual return to investors in a real estate investment fund which involved a $125 registration fee and a 5 percent fee to the financial planner. Investors were told that would receive a $1,000 bonus and a fixed income for 10 years, if they brought in at least 100 new participants.

- The operator of a Waltham-based investment adviser firm faced 10 larceny counts on September 12, 1986 for the theft

on nearly $1 million from at least 10 investors. Investors were told that the pooled investment funds would be safe and bring an extremely high return. The state found evidence that the funds had been converted to the financial planner's personal use in real estate, a Mercedes Benz automobile, motorcycles and antiques. The court action was proceeded by a May 20, 1986 shut down of the firm by state securities regulators.

MISSOURI

- A July 15, 1988 raid of a 15-person financial planning firm in Kansas City, Mo., was conducted by the securities division of the Secretary of State. An estimated 100 investors lost $3 million in a scheme that involved supposedly government-guaranteed bonds that were promoted to some investors as a means of financing the college education of their children. Evidence turned up in the state raid suggests that the financial planning firm had recoverable assets of just $400 in one bank account. A temporary restraining order was entered by the state on July 18, 1988 in order to stop the firm from soliciting new investors. Further action is expected as the state's investigation continues.

- A SEC registered investment advisor and newsletter publisher faced a 13-count indictment on July 17, 1987 in what has been described by Secretary of State Roy Blunt as "the largest commodities scheme in state history." The financial planner is estimated to have tied up $30 million in now unaccounted for investor funds in contracts for deferred delivery of South African platinum. The contracts offered platinum at a $100 an ounce discount in exchange for a 45-60 day delay in delivery. In order to slow investor suspicions about the deal, the promoter encouraged the rolling over of platinum "profits" into new contracts. The state's investigation into this variation on the classic Ponzi scheme determined that the South African mine in question had never done business with the promoter and did not even produce the five ounce platinum bars referred to in the contracts.

- Ten state residents lost $200,000 during 1986 to a financial planner who promoted oil and gas well investments at a trade show in Denver. According to a state investigation, the promoter misrepresented the production capacity of the wells, some of which appeared to be dry holes, and also suggested investors had full ownership of the wells, when, in fact, they owned just a fraction of 75 percent of two or three different wells. The financial planner, who has been

cited in national publications as an expert on limited partnership investments, also encouraged some of the victims to purchase an unregistered over the counter (OTC) stock in an oil company. The promoter failed to disclose that he had an interest in both the oil company and the brokerage firm he urged the victims to use for the stock purchases.

NEBRASKA

- A Chadron financial planner was ordered in December 1987 by the Nebraska Bureau of Securities of the Department of Banking and Finance to return at least a portion of funds given to him by 10 Nebraska investors. The promoter offered investors a chance to participate in a high-yield investment pool and a "middle class" tax shelter that was supposed to have a potential for producing income. The state held that some of the investments offered were of extremely dubious value and others were outright scams. The disallowed tax deductions and penalties imposed on investors in the tax shelter scheme total to more than $100,000.

- The state is now proceeding with an investigation in which an Omaha investment advisor is suspected of causing 25 novice investors to lose at least $375,000 in unsuitable investment strategies. Formal action is expected soon in this case.

- An Omaha investment adviser registered with the SEC was sentenced in 1986 to serve five years in jail and make restitution of $221,000 to 17 investors in a mutual fund schemes. The promoter convinced at least 100 investors to give him over $400,000 for investment in T. Rowe Price mutual funds. Victims were recruited through individual and group meetings, including financial planning seminars. The Omaha man required participants to sign an "investment advisory agreement," which gave the financial planner powers of attorney. The state found that while a few accounts were maintained properly for some clients, a substantial share of the investor dollars went directly into the financial planner's pocket.

NEW JERSEY

- Opening arguments began July 6, 1988 in the trial of a Point Pleasant couple and their daughter on charges of defrauding 200 investors of $3.5 million in an insurance premium financing scheme. The Bureau of Securities of the Department of Law and Public Safety charged that the bogus

"thrift certificates" promoted by the trio under the guise of financial planning were presented falsely as legitimate investments bearing a high rate of interest guaranteed by the state of New Jersey. The Point Pleasant man who appears to have masterminded the scheme operated both an insurance agency and an insolvent securities firm, which he had unsuccessfully tried to take public in 1973. The promoter failed to disclose to investors that the brokerage firm had been the subject of state and National Association of Securities Dealer (NASD) actions in 1983. The prosecutor in the case has described the scheme as "a massive, heartless, cruel fraud perpetrated on in many cases people who could least afford investing ..."

- A financial planner who is serving a five year term for securities and mail fraud in which 13 investors lost at least $567,000 is suspected of continuing to contact investors from prison. The promoter claimed to be placing investors in mutual funds, but simply converted most of the funds to his personal use. The Bureau of Securities revoked the financial planner's broker registration in the fall of 1987. There are indications that the planner tried to sell as much as $750,000 in unregistered securities between the time of entering his guilty plea and right up to the moment of his incarceration.

- A New Jersey man was enjoined by the state and sentenced to five years in prison in 1987 for selling more than 65 investors preferred stock in an investment company that he ran. Investors were told that the 12-40 percent rates of return on the stock were guaranteed. Investor losses in the case are estimated to exceed $500,000.

- A New Jersey financial planner was given a 10-year prison sentence in 1987 for a scheme in which he sold 47 investors $750,000 worth of stock in an imaginary company. The promoter told his victims that the nonexistent company was a subsidiary of a major New York Stock Exchange-listed firm and that it had offices in the World Trade Center in New York City.

- The state revoked the broker registration of a Fairfield financial planner in September 1987 when he attempted to hide the fact that he had taken $35,000 from an Atlanta woman's IRA account. In an October 1986 settlement with the woman, the financial planner said he was a "compulsive gambler" who used the funds for wagering "and other purposes." The financial planner also failed to provide the details on his 1979 personal bankruptcy proceedings.

- A New Jersey financial planner conspired with partners in Florida, Georgia and Washington state to recruit investors

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for a phony German mutual fund. The case, which remains under investigation, is believed to involve $700,000 in investor losses in New Jersey alone.

NEW YORK

- The largest fraud case ever lodged against a financial planning firm in the United States was filed on November 5, 1986 by Attorney General Robert Abrams. An Albany-based financial planning firm employing 18 salespeople solicited over $55 million in investments in real estate, coins and art from almost 1,000 investors in four states -- New York, Connecticut, Massachusetts and New Hampshire. Describing the firm as "nothing more than a sales gimmick," the state charged that the financial planners failed to: (1) accurately describe the terms of their services, inaccurately stating that no commissions would be earned on implementation of plans, even though at least $8 million was derived in this manner; (2) explain that the firm had a vested interest in a number of the investment programs; (3) disclose that the background of a key promoter included a felony conviction in Massachusetts for conspiracy to violate gambling laws; (4) acknowledge the true value of investment programs, including grossly overvaluing the value of, and potential rate of return on, Florida condos and art produced by Albany area artists. While the financial planners claimed to do business with only appropriate investors, "...if the investor had access to cash he had about as much chance of being turned down as of being rejected by the Book of the Month Club," Abrams stated. Though the planners promised to develop a "balanced portfolio" matching the specific needs of individual investors, the same real estate-coins-art formula was applied in all cases. The Florida condos were described as "conservative, low-risk" investments with a likely annual return of 11-16 percent plus tax advantages, but were, in fact, sold at inflated prices (which included a hefty 9 percent commission) and located in glutted markets that made the prospects of resale dim. The investigation by Abram's Bureau of Investor Protection and Securities also found that the key promoter's chief "qualifications" as a financial planner consisted of a high school diploma and brief stints an insurance salesman and supervisor of a Massachusetts Thruway toll station.

NORTH CAROLINA

- Fraud charges were filed on February 22, 1988 against a Chapel Hill financial planner accused of taking 14 investors

for as much as $2.3 million in schemes involving real estate developments and U.S. government bonds. In one of the largest embezzlement cases in state history, the promoter was accused by the Securities Division of the Department of State of diverting most of the investor funds into companies he controlled. While the civil action filed by the state immediately placed the financial planner's enterprises into receivership, it appears there are not enough remaining assets to cover even the cost of the receivership proceedings.

- A fugitive Hendersonville financial planner faced civil charges on February 9, 1988 in a case in which he acquired a $100,000 loan using a dead client's stock as collateral. The woman's estate sued the planner when the loan was defaulted upon and the bank seized the stock for sale. The Hendersonville also has been accused in Chicago of participating in a scheme with three accomplices who used wigs, makeup and fake identification to gain access to the trading floor of the Chicago Board of Trade. The profits from the fraudulent commodities trading activities are estimated at $200,000.

- A routine investigation in 1986 of a Winston-Salem financial planner's application for state registration as a securities broker uncovered hundreds of securities law violations committed by the planner. The state Securities Division identified $7.2 million of unlawful sales to 141 investors, few of whom are expected to get back even a few cents on the dollar.

OHIO

- "High yields are our specialty" was the widely-advertised motto of a Kent financial planner who faced a two count indictment in July 1988 as a result of an investigation by the Division of Securities of the Department of Commerce. The promoter placed more than $5.3 million in investor funds in what he claimed was a complex array of investment programs, including coins, diamonds, gemstones, cattle breeding, gold mining in French Guyana and Costa Rico, time-share condos in Utah and exotic tax shelters. The financial planner failed to disclose to investors that he earlier had faced more than half a dozen investor lawsuits when the Internal Revenue Service (IRS) disallowed $800,000 in credits claimed for an abusive audio tape leasing and distribution program. The state investigation of the Kent man's financial planning service indicated that he had potential unsecured liabilities of $4.5 million. The promoter declared bankruptcy in September 1986 just two

weeks before a $3.5 million investor suit was scheduled to got trial. But his activities as a financial planner did not end there. The financial planner used $2,240 in July 1987 to buy from the bankruptcy trustee the furniture from his defunct firm and then opened up a new financial planning office. The promoter peddled his services through newspaper ads and seminars in the Akron area. He indicated that he was seeking $5,000 minimum investments and promised an 18-20 percent annual return "with a minimum of risk" in prime farm land that supposedly was to be leased for papaya farming near Montego Bay, Jamaica. One of the victims of the planner's first firm said: "I'd have been better off putting it (money) in a mattress."

- A state investigation is still underway into the activities of two Strongville financial planners who recruited more than $1.6 million from investors for investments in IRAs, limited partnerships, real estate and loans secured by promissory notes. The two operated a tax preparation firm and identified investors with money to spare for investments which were promised to return 12-14 percent annual interest. It appears that the promoters diverted the funds into their own interests in restaurants and office construction.

- The state suspended on March 2, 1988 the operations of a Worthington financial planner who had assets of just $276,000, in spite of the fact that he had raised $4.6 million in investor funds for a mysterious and little-explained "mortgage note pool." Operating between 1982-1987, the planner promised as much as 14 percent annual interest to 120 investors.

- A Cincinnati financial planner was put of business by the state on January 14, 1988 when an investigation determined that he had placed $170,000 of an elderly woman's funds in a brokerage account and then, without her knowledge, invested $125,000 in notes of a corporation he owned.

OKLAHOMA

- Criminal prosecution by the Oklahoma Securities Commission is ongoing against a Tulsa financial planner who urged all of his clients to buy more than $2 million in unregistered securities issued by three largely inactive companies that he owned. The planner said that the investments were part of a grand financial scheme, the arcane details of which he alone could fathom, or so he claimed. The Tulsa man also is suspected of taking another $3-4 million in an array of unrelated but equally mysterious schemes. State

investigators found no records of the financial planner's business activities.

- Sentencing is scheduled in August for an Oklahoma financial planner who used his position as an estate planner to identify investors over the age of 60 to underwrite a series of phony business enterprises. The promoter was convicted in 1986 of securities fraud, but is now suspected of continuing to make sales pitches to potential financial planning clients, this time in Texas.

- The state of Oklahoma moved quickly in April 1988 to shut down a Tulsa-based financial planner, who attempted to entice "senior depositors" through a massive direct mail campaign. The promoter issued promissory notes as a guarantee of his claim that he could put investor funds in zero coupon bonds that would bear annual interest seven full points above prevailing Treasury Bill rates. The financial planner had received just $15,000 from two elderly investors at the time the state issued its cease and desist order.

OREGON

- A Salem financial planning firm piled up an estimated $32 million in investments from 925 investors from across the nation and England prior to November 1987, when action was taken by the Division of Finance and Corporate Securities. Most of the victims were born again Christians who had been recruited through presentations at Christian churches, social meetings and colleges, and advertisements on religiously-oriented radio stations in the state. The scheme involved investments in real estate supposedly secured by first and second trust deeds and promissory notes. In some case, investors did not receive a trust deed and note as promised. Though the investments were promoted as safe and carrying a yield of 17-18 percent, the scheme ran into trouble when borrowers started defaulting on the loans on the generally low-quality properties. The financial planners then resorted to Ponzi scheme tactics--using new investor funds to make the promised high payments to earlier investors. The foreclosure rate on the more than 250 properties involved in the financial planning fiasco now stands at about 90 percent. The firm was forced into bankruptcy proceedings in December 1987. State officials do not expect that more a few cents on the dollar will ever be returned to investors.

PENNSYLVANIA

- The Pennsylvania Securities Commission moved on October 15, 1987 to suspend the massive financial planning scheme of an Allentown man who was registered with the SEC as an investment advisor. As much as $5 million a year in losses may have been sustained from 1984 on by investors who were convinced to invest in debt and securities issued by a Maryland corporation. The state investigation found indications that the financial planner had engaged in the doubling selling of some of the interests and also diverted investor funds to his use, including hefty "commissions" of $300,000 or more each year. Investors are now awaiting the outcome of bankruptcy proceedings that have so far shielded the finances of the Allentown financial planner.

- A Reading financial planner was blocked by the state in September 1987 after he induced at least three people to invest more than $26,000 in undefined investments. The self-proclaimed investment advisor promised returns ranging from $16.5-20.9 percent. No evidence was discovered indicating that any of the investments were ever made. Bank records, however, showed that at least $17,000 in investor funds had been used for the Reading man's personal expenses.

TENNESSEE

- Criminal prosecution is in the offing for a Nashville man who was a registered representative of a broker dealer and then established a separate office and business entity in order to sell financial services, including financial planning. He produced slick brochures that promised interest rates of 16-40 percent in return for funds that would placed in the stock market, real estate deals, short-term notes and bridge loans to contractors. More than 40 investors placed about $1.2 million with the financial planner, whose conduct was the result of a state administrative complaint in October 1986. Substantial amounts of the investor funds went to the planner's personal use and supported him in an extravagent lifestyle.

TEXAS

- A San Antonio financial planner was indicted on May 13, 1988 for pocketing the funds involved in the sale to two individuals of $1.6 million in real estate limited partnerships. One investor gave the financial planner the proceeds from the sale of a ranch and the other Texan turned

over the money from an inheritance. The Texas Securities Board had revoked the San Antonio man's broker-dealer registration the previous month for the sale of unregistered securities to 35 Texans. The promoter, who also attempted to attract backing for an obscure "energy management system," failed to inform investors that (1) he had filed for bankruptcy in Illinois in 1978 and again in 1987; and (2) he had been ordered in October 1984 by a federal court in California to pay $5 million in answer to a $16 million lawsuit.

- Another San Antonio man was indicted on May 18, 1988 for his promotion of a home loan scheme in which hundreds of investors, most of them elderly, lost $8.3 million. One victim, a 70-year-old woman, lost her entire retirement savings and was forced to go back to work. The financial planner's told investors that they were banding together to purchase second lien real estate notes and home improvement loans in $100,000 blocks from financial institutions. The proceeds from the notes and loans were to be placed in short-term, high-interest reserve account until needed as labor and mechanics liens were filed and individual properties were sold. Returns of as much as 27 percent were promised in the scheme. The San Antonio man was put out of business by the state in 1986 and then filed for Chapter 11 reorganization bankruptcy in April 1987.

- Senior citizens were the target of a Dallas-based, though seemingly international, financial planning firm entitled, "International Society of Senior Citizens." More than 100 older investors were recruited to invest upwards of $3 million in a complex of five related companies with impressive and exotic sounding titles, which included the words "Dunhill," "Carribean," "Pope," "Swiss," and "Nassau." Some seniors were told that their funds were going to a British West Indies trust supposedly operating out of the Turks Islands. Other elderly investors were placed in nonexistent annuities, which supposedly returned 13 percent annually "tax free". One of the principal promoters of the financial planning firm was convicted of fraud on May 7, 1987.

UTAH

- A Salt Lake City financial planner acknowledged that he used investor funds under his management to pay for radiation treatments that his son was undergoing for cancer, according to a consent agreement secured on July 13, 1988 by the Securities Division of the Department of Business Regulation. The state had shut down the operations of the

Senator DODD. Thank you very much. Mr. Wilson.

STATEMENT OF FRANK J. WILSON, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, WASHINGTON, DC

Mr. WILSON. Thank you, sir. My name is Frank Wilson. I am executive vice president, legal and compliance, and general counsel of the NASD. The NASD is a self-regulatory organization which regulates the securities activities of some 6,700 firms and approximately 470,000 registered representatives who are associated with these member firms.

Under the provisions of the Maloney Act, which is an amendment to the Securities Exchange Act of 1934, passed in 1938, the NASD has been the sole self-regulatory organization of the over-the-counter securities markets for almost 50 years. Presently the NASD also regulates the NASDAQ market and has examination and compliance responsibility over all broker/dealers in the municipal securities market and non-New York Stock Exchange members in the Government securities market.

Except in situations involving business fraud or similar egregious activity, the NASD does not possess the statutory authority to regulate the nonsecurities activities of its members.

As you know, the Federal statute that governs investment advisers is the Investment Advisers Act of 1940. Firms that give investment advice about securities for compensation are required to register under this statute. NASD members who give investment advice about securities that is not incidental to their regular securities business or for which they receive compensation in addition to that which they receive for offering securities are required to register with the SEC as investment advisers or "RIA's," as they are known. The NASD does not possess the statutory authority at this time to enforce the provisions of the Investment Advisers Act. Such is the sole responsibility of the SEC. Consequently, NASD members or their employees who are registered as investment advisers are subject to NASD regulation with respect to the offer of securities but are not subject to NASD regulation to the extent that they give investment advice about securities for which they charge a fee.

The NASD has been aware of the growth of the financial planning industry during the past several years and the various regulatory initiatives that have been pursued at both the Federal and State levels. Since 1985, the NASD has conducted two studies of financial planners and their regulation with a view toward formulating an NASD policy toward such regulations. In addition from August 1986 through March 1987, the NASD, with the cooperation of the SEC staff, conducted a pilot program during which field examinations were conducted by NASD examiners of the investment advisory activities of certain members who were registered as RIA's. More than half of the RIA's were financial planners.

I stated the objectives of that pilot program in my statement.

NASD POLICY

As a result of the studies and the successful completion of the pilot program in May 1987, the NASD Board of Governors adopted the policy which appears in appendix A to my statement as submitted to the committee.

Briefly, the policy expresses the willingness of the NASD, if requested, to become the SRO or registered investment advisers who are NASD members or employees of NASD members or for entities that are not NASD members but whose employees include personnel who are associated persons of NASD members.

We would also be willing to consider including within the scope of the NASD's regulatory authority those RIA firms that are affiliates of NASD members but who do not have employees also associated with an NASD member.

There are, of course, many persons and firms who hold themselves out as being financial planners and who are not affiliated in any way with an NASD member firm. These may or may not be registered as RIA's. The policy proposed by the NASD at this time would not extend NASD jurisdiction to these financial planners; however, in an earlier statement, I believe, before this committee, the NASD has said that it would be willing to consider after it gains a period of experience extending its authority to that.

For a number of years, the SEC has taken the position that since financial planners invariably give investment advice about securities as part of their services, they are required to register as RIA's. Most financial planners not only give advice about securities but also offer securities to implement their recommendations. Thus, a majority of the financial planners are already registered with the NASD to sell securities. More than half of all advisers registered with the SEC are NASD members or associated persons of members, and many hold themselves out as being financial planners.

Since the NASD has had considerable experience in the craft of self-regulation and since so many financial planners registered as RIA's are already associated with NASD members, it was a logical step for the NASD to offer to become the SRO for these RIA's to assist the SEC in discharging its regulatory responsibilities.

One alternative that has been suggested by others is the creation of another layer of regulation at the Federal level by the formation of a separate SRO for financial planners. In our judgment, this proposal has little merit, as it would impose more regulation on many firms and persons who are already subject to regulation by four regulatory authorities: the SEC, the NASD, State Securities Commissions and, in many cases, the State Insurance Commissioners. In addition, the start-up expense of a new SRO would be substantial and would be largely borne by those already subject to substantial regulation.

Mr. Chairman, thank you very much.

[The complete prepared statement of Frank J. Wilson follows:]

STATEMENT OF FRANK J. WILSON, EXECUTIVE VICE PRESIDENT, LEGAL AND COMPLIANCE AND GENERAL COUNSEL, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. BEFORE THE SUBCOMMITTEE ON CONSUMER AFFAIRS OF THE U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE, JULY 26TH, 1988.

My name is Frank Wilson and I am Executive Vice President, Legal and Compliance and General Counsel of the National Association of Securities Dealers, Inc. ("NASD"), the self-regulatory organization ("SRO") that regulates the securities activities of some 6,700 firms who are broker/dealers registered with the Securities and Exchange Commission ("SEC") and the approximately 470,000 registered representatives who are associated persons of these members firms.

NASD members engage in every conceivable kind of securities activity. The range of securities products they offer encompasses all securities registered with the SEC and some that are not. In addition, many NASD members and/or their affiliates engage in the offer of other financial products and services such as investment management, insurance, banking, real estate and financial planning.

SCOPE OF THE NASD REGULATORY AUTHORITY

Under the provisions of the Maloney Act, amending the Securities Exchange Act of 1934 in June 1938, the NASD has been the sole SRO of the Over-the-Counter ("OTC") securities markets for almost 50 years. Presently, the NASD also regulates the NASDAQ market and has examination and compliance responsibility over all broker/dealers in the municipal securities market and non-New York Stock Exchange members in the government securities market.

Except in situations involving business fraud or similar egregious activity, the NASD does not possess the statutory authority to regulate the non-securities activities of its members.

The Federal statute that governs investment advisers is the Investment Advisers Act of 1940. Firms that give investment advice about securities for compensation are required to register under this statute. NASD members who give investment advice about securities that is not incidental to their regular securities business or for which they receive compensation in addition to that which they receive for offering securities, are required to register with the SEC as investment advisers ("RIAs"). The NASD does not possess the statutory authority to enforce the provisions of the Investment Advisers Act. Such is the sole responsibility of the SEC. Consequently, NASD members or their employees who are registered as investment advisers are subject to NASD regulation with respect to the offer of securities but are not subject to NASD regulation to the extent that they give investment advice about securities for which they charge a fee.

THE NASD AND FINANCIAL PLANNER REGULATION

The NASD has been aware of the growth of the financial planning industry during the past several years and the various regulatory initiatives that have been pursued at both the Federal and State levels. Since 1985, the NASD has conducted two studies of financial planners and their regulation with a view to formulating an NASD policy towards such regulation. In addition, from August 1986 to March 1987, the NASD, with the cooperation of the SEC staff, conducted a pilot program during which field examinations were conducted by NASD examiners of the investment advisory activities

Salt Lake City man in June and learned that $500,000 in investments from 96 area residents were missing. The planner, a registered broker-dealer, guaranteed investors that they would earn 15 percent annually on a mix of investments in leases, second mortgages, life insurance, stocks and bonds. The financial planner issued false statements to create the illusion that big returns were going into the investors' accounts. None of the funds, some of which were believed to have been diverted for the purchase of automobiles, have been recovered.

- Utah's economy would be "revolutionized" and 65 state residents would be transformed into millionaires in as short a time as 18 months under claims made in a California-based pyramid scheme that was marketed in 1987 and 1988 to financial planners in Utah. For an initial fee of $149.95 and subsequent monthly payments of $49.95, a Utah financial planning firm offered residents entry into the pyramid scheme. Investors were told that they could make more than $1.8 million in no more than 18 months by recruiting five new participants, who, in turn, would have to recruit five more participants, and so on, until six levels of the pyramid were filled out. Promoters failed to disclose that for the scheme to work it would require the recruitment of 19,530 investors who would have to make each and every one of their monthly payments. If, as the promoters pledged they would do, 65 Utahans were to be made millionaires the pyramid way, more than 1.2 million investors would be needed. The financial planning firm broadened the appeal by creating a phony "buyer's club," offering investors 28 unrelated services, including credit counseling, low-cost insurance, prescription drugs at reduced prices, cut-rate travel, bargain long-distance telephone service and "hundreds of dollars" in reduced monthly grocery store bills. The state shut down the firm's promotions on April 1, 1988 after spotting an advertisement in a Provo newspaper.

VIRGINIA

- A Richmond area financial planner was convicted on eight counts of grand larceny on June 29, 1988 in scheme in which eight investors lost $980,000. The planner promised a high rate of return on general investment activity, but simply deposited investor checks in his personal bank account. The promoter was registered with the SEC as an investment advisor. He now awaits sentencing.

- The stiffest prison sentence handed out to any financial planner in the United States came in September 1987 when

Jukka Pekka Vihko, a native of Finland, was convicted on 36 counts of securities fraud and embezzlement, which were first detected by the Division of Securities and Retail Franchising. Vihko, who stole $1.3 million from 40 investors in eight states, was sentenced to serve 222 years in a Virginia prison. Among Vihko's victims was his own grandmother-in-law, a Gaithersburg, Md., woman who invested $20,000 with the Finn to help get his financial planning service off the ground. The financial planner solicited funds from individuals for general "investment purposes" in exchange for certificates, which he promised to redeem after three months with 20-60 percent interest. Vihko told his victims that: (1) he was not required to register as a broker-dealer; (2) that there was no risk of loss since the funds were insured for up to $1 million; (3) that the repayments he would make on certificates qualified as "dividends" and, therefore, were tax exempt. The state investigation determined that Vihko actually used the funds for personal expenses, including real estates, autos and a account in his name for trading in S&P 100 index options.

- A Richmond area man was sentenced in 1987 to five years in prison in a scheme that was intended to keep his coin and stamp shop in business. The financial planner was accused of taking $85,000 from five investors, who were told that their funds would go into coins, stamps and real estate. The Richmond man apparently used some of the investor funds to underwrite his travel to coin shows around the country.

WASHINGTON

- Teachers were the targets of a Tacoma financial planner who set up tax-deferred compensation plans that resulted in losses of $155,000 for more than a dozen state residents. In his job as savings and loans official, the Tacoma man had access to personal financial information that he used to identify potential victims. The financial planner also had worked as a licensed stockbroker until January 1987, when he was forced out of the business by the Securities Division of the Department of Licensing, Business and Professions Administration. Nonetheless, the financial planner misrepresented himself to investors as a licensed broker, a lawyer and an all-around financial expert. The state shut down the Tacoma man's financial planning scheme in June 1988.

- A Vancouver, Washington, financial planner was arrested on March 29, 1988 in Fairbanks, Alaska, after fleeing Washington state and hiding out for a year in Saipan to avoid facing securities fraud charges. The Vancouver man

was the key promoter behind an off-shore bank scam that cost 400 investors an estimated $7 million. In mid-1983, the financial planner arranged to license in the Marshall Islands an entity known as First Colonial Banking, Ltd. An investigation by the state and the Federal Bureau of Investigation determined that the only bank "officer" resident in the Marshall Islands was a gas station operator who went to a local post office box and remailed investor checks to the financial planner's firm in Vancouver. The promoter told investors that they could earn 30-40 percent a year by participating in the phony banks' CDs, precious metals and "arbitrage trading" programs. With an accomplice who worked at an electronics firm in Beaverton, a large number of victims were recruited among employees of the high-tech manufacturing plant. The financial planner failed to disclose to investors that just three months before First Colonial Banking "opened" for business, he had been ordered by the state to suspend the operations of his accounting and tax preparation firm, which had been implicated in a number of suspect investment deals. The state found that the financial planner had diverted investor funds intended for the foreign bank into a film project and gold mine investments. When the Ponzi scheme collapsed, the promoter sent a letter from Susupe, Saipan, to investors and pledged to "remain abroad" until he got to the bottom of the "collapse" of the Marshall Islands bank.

- An Issaquah financial planner was accused in a spring 1988 lawsuit of establishing a massive unregistered "debenture bank," a sort of real estate loaning operation, strictly for the purpose of making undisclosed loans to his own enterprises. The scheme left 7,000 "depositors" hold $56 million in defaulted notes. Many of the victims were Puget Sound area evangelical Christians who were recruited through church groups and advertisements placed on religiously-oriented radio stations. Many of the investors were told that a portion of the promoter's returns would be earmarked for Christian mission work. Instead, the financial planner drew an estimated $480,000 a year in commissions and other fees. Investors were given notes that the promoter said would bring a return of 12 percent annually. When he was not able to make the payments, the Issaquah man unsuccessfully attempted to convince the investors to refinance the debt at the lower rate of 8 percent. Of the three major firms in the control of the promoter, only one has escaped bankruptcy and it is valued at no more than $2.1 million. The matter is now in the hands of a bankruptcy court.

- A Lakewood man was sentenced in 1987 to five years in prison for stealing $700,000 from 18 investors in a complicated and largely imaginary scheme involving deeds of

trust, promissory notes and corporate debentures. The financial planner issued unregistered one-year bonds promising 15.9 percent annual interest. Investors learned too late that the promoter's track record included an earlier 1984 state order against his activities in the sale of unregistered securities.

- The state moved in 1987 to end the activities of six Bellevue residents accused of operating a trio of boiler room telephone sales operations in Bellevue Newport Beach, Calif., and El Toro, Calif. in which investors entrusted $8.5 million for phony oil-well completion contracts and futures contracts in precious metals. Prior to the state action, the Bellevue promoters, who advertised themselves as financial planners, had been planning to set up a 13-car caravan to spread new boiler room operations to points across the nation.

WEST VIRGINIA

- A plea is expected shortly from a St. Albans financial planner who faces criminal charges in the theft of more than $1 million from 20 investors in the Charleston area. The promoter claimed to have "inside information" about pending Wall Street deals and told investors that their funds would return at least 30 percent a year. Many of the investors first met the financial planner at a local donut shop. The owner of the donut shop, who is thought to personally have recruited several investors, was shot in the head shortly after news stories appeared about the Securities Division of the Auditor's Office July 1988 action in the case. Authorities have stated that one possible suspect in the shooting is a disgruntled investor. The store owner remains in critical condition today.

- A Hurricane financial planner is under investigation by the state for more than $450,000 lost by 31 investors in real estate limited partnerships and heavy equipment leasing programs. The promoter, who is a registered SEC investment adviser, is suspected of having diverted some investor funds and misrepresenting the value of the investments. Most of the investor funds now are unaccounted for and the limited partnerships are in default.

WISCONSIN

- A Milwaukee financial planner was ordered by the Office of the Commissioner of Securities on May 2, 1988 to stop

providing investment advice after he issued worthless promissory notes to at least two investors for $100,000. The financial planner failed to mention that his firm had 1987 losses of $800,000 and a negative net worth of $500,000.

- Industrial floor pads, pet food, fishing scent lures and experimental turbine wind energy machines were among the offbeat investments promoted by a Janesville financial planner who was shut down by the state in March 1987. The 139 area residents who invested with the financial planner lost $2.4 million in the combination of exotic investment programs. The floor pads, pet food and fishing scent lure were to be produced by Wisconsin companies that the Janesville man had taken an interest in getting established. The profit potentials of the unusual start-up enterprises were misrepresented to investors, according to the state. Most of the investor losses came in the $2 million in rejected tax deductions and related penalties and interest arising from the turbine wind energy program. Though the financial planner told investors that the new energy source was fully operational and already turning an attractive profit, the turbine program had, in fact, generated a grand total of $90.40 worth of electricity in three years. The promoter failed to mention to investors that the turbine program had never advanced from a bench-scale model that was used for design purposes. No full-scale turbine was ever operated, the state pointed out.

of certain members who were registered as RIAs. More than half of these RIAs were financial planners.

The objectives of the pilot program were to:

1) Develop methods and procedures for regulating RIAs.
2) Evaluate the cost of such regulation to the NASD.
3) Determine how this cost would be defrayed.
4) Determine how affected RIAs might be absorbed into the NASD's regulatory scheme if the NASD was given the authority to regulate RIAs.

As a result of the studies and the successful completion of the pilot program, in May 1987, the NASD Board of Governors adopted the policy which appears at Appendix A of this statement. Briefly, the policy expresses the willingness of the NASD, if requested, to become the SRO for RIAs who are NASD members or employees of NASD members and for entities that are not NASD members but whose employees include personnel who are associated persons of NASD members.

We would also be willing to consider including within the scope of the NASD's regulatory authority those RIA firms that are affiliates of NASD members but who do not have employees who are associated persons of an NASD member.

There are, of course, many persons and firms who hold themselves out as being financial planners and who are not affiliated in any way with an NASD member firm. They may or may not be registered as RIAs. The policy would not extend NASD jurisdiction to these financial planners.

RATIONALE FOR THE NASD POLICY

For a number of years the SEC has taken the position that, since financial planners invariably give investment advice about securities as part of their services, they are required to register as RIAs. Most financial planners not only give advice about securities but also offer securities to implement their recommendations. Thus, a majority of financial planners are already registered with the NASD to sell securities. More than half of all the advisers registered with the SEC are NASD members or associated persons of NASD members. Many hold themselves out as being financial planners.

The SEC, faced with a rapidly increasing number of RIA registrations in a time of budgetary constraint has had great difficulty in coping with the regulation of more than 12,000 RIAs particularly in view of its increasing responsibilities in other areas of securities regulation.

Since the NASD has had considerable experience in the craft of self-regulation and since so many financial planners registered as RIAs are already associated with NASD members, it was a logical step for the NASD to offer to become the SRO for these RIAs to assist the SEC in discharging its regulatory responsibilities. One alternative that has been suggested by others is the creation of another layer of regulation at the Federal level by the formation of a separate SRO for financial planners. In our judgement this proposal has little merit as it would impose more regulation on many firms and persons who are already subject to regulation by four regulatory authorities - the SEC, the NASD, the State Securities Commissioners and the State Insurance Commissioners. In addition, the start-up expense of a new SRO would be substantial and would be largely borne by those who are already subject to substantial regulation.

As the foregoing background information demonstrates, the NASD's experience with financial planners has been minimal and should serve to put the following answers to the questions posed in Chairman Dodd's letter of July 7th in their proper context.

1. What are the most frequent kinds of abuses consumers face in dealing with financial planners and how widespread are such abuses?

The NASD regulates members and their associated persons who offer securities. Some are financial planners. The NASD proceeds against its members and their associated persons who violate Federal securities laws and NASD rules. We do not keep records identifying whether a person subject to an NASD disciplinary action is or is not a financial planner. Thus, we cannot answer this question from information contained in our files.

NASD studies, using information obtained from other sources, indicate that the most frequent abuses by some persons who hold themselves out as financial planners occur in the implementation phase - when the products to fulfill the plan are offered - and usually involve fraud. Invariably, such fraudulent activity involves violations of Federal and State laws and/or NASD regulations. To our knowledge, all such cases of customer abuse by financial planners which have come to the attention of the regulatory authorities have been subject to or prosecuted under laws already in place.

2. Is the current statutory scheme adequate to protect customers against unscrupulous financial planners?

In our view, their is no necessity for additional Federal laws or new SRO's at the Federal level to regulate financial planners. As we have said, most financial planners are already subject to SEC, State and/or NASD regulation. Vigorous enforcement of current laws and regulations is the answer; not a proliferation of new laws that would duplicate those that are already in place.

3. Do inspections conducted by the SEC and State Securities Administrators effectively deter abusive practices?

Since information about inspections conducted by the SEC and the States are not made available to the NASD we cannot respond to this question.

4. What changes in the law and/or regulations would you recommend to reduce customer abuse in this area?

As we have suggested elsewhere in this statement, our view is that if the SEC and the Congress wish to permit the NASD to become the SRO for RIAs as described in our attached policy statement, the only changes necessary in the current Federal laws would be amendments to the Securities Exchange Act of 1934 to enable the NASD to implement the policy of the NASD Board of Governors.

Thank you for the opportunity to address the Committee in this important area.

Senator DODD. Thank you very much, Mr. Wilson. We appreciate your being with us. I have some questions.

Let me first of all move back to Mr. Meyer, and again, I want to thank Mrs. McGrath for staying around this morning, and I wanted to have both, often as we have the Federal people and then people from the States, and we don't get the opportunity to get some interchange between the representatives. And I'd like to first of all commend both of you again for what NASAA has done, as well as the SEC, with limited resources and so forth in this area. But I would like to raise some suggestions to you, and I would like to get your comments on them as to various options that might help out in this area, and I am not limiting this to Federal or State. You can suggest, if you'd like, that this more properly should be done at the State or the Federal level. But let me just mention several options to you and ask you to comment on them as options that are all, by the way, not mutually exclusive, I would suggest to you.

Some of them you have already responded to, Ms. McGrath, but I'll raise them again anyway.

Establishing one set of disclosures, set of disclosures for all persons to give financial planning advice for compensation, breaking down the distinction between investment advisers and financial planners. Just one set of requirements for both.

ONE SET OF REQUIREMENTS

Mr. MEYER. Well, there is a peculiar set of law and requirements that has been developed through years of law and practice in the regulation of the securities business. I am not sure all those principles may be applicable to the selling of other financial instruments such as securities. And those of us who have been looking at the proper architecture as to how investment advisers or financial planners ought to be regulated, over the past couple of years, have come to one inescapable conclusion, and that is that the architecture of investment adviser legislation is probably the best vehicle for doing that. There are obviously some financial planners who do not give investment advice concerning securities. In fact, probably the universe of persons who do that is very small, and I would endorse having requirements for persons in other financial disciplines to make disclosure to their customers about whether instruments they are selling, regardless of what they are, but I am not sure that they can be comfortably folded in to one scheme of regulation.

Senator DODD. So your concern is the regulation, but the notion of having one set of disclosures——

Mr. MEYER. The principles, I think, could be applied to other financial disciplines and other regulatory schemes, but what I am suggesting is that we do have a system in place, if it is properly implemented and funded and the resources are properly allocated, which should impose proper disclosure requirements upon those who give financial advice in connection with the sale, purchase or investing in securities.

Senator DODD. Mrs. McGrath.

Mrs. MCGRATH. Well, what you are suggesting, I think, would mean that anybody that uses the title "financial planner" or some-

thing similar would have to be regulated, in effect, by States and by us, as an investment adviser and subject to those requirements maybe beefed up a little. That, in the abstract, makes sense, but it has always seemed to us that the opposition it would draw from real estate businesses and their regulators, from insurance businesses and their regulators, from broker/dealers, who have now attached the label "financial planner," "financial consultant," what have you, to the guys who used to be registered reps and then account executives, would be so great that as a practical matter, it wouldn't happen.

Senator DODD. How about the—and we have raised some of this before. How about the idea of mandatory, not voluntary, disclosure or certification requirements, excuse me, for financial planners, as well as, obviously, investment advisers?

Mr. MEYER. I'm not sure—when you use the term "financial planners," Senator, are you referring to anyone who characterizes themselves under the rubric of financial planner?

Senator DODD. Well, generally, yes, for lack of a better description at this particular point, but getting beyond, obviously, the definition of an investment adviser. So you are expanding that.

Mr. MEYER. Well, absolutely. I think that is a laudable goal, and I think it would be a welcome regulatory development.

Senator DODD. In other words, you are holding yourself out in that notion of being a financial planner.

Mr. MEYER. That is correct.

Senator DODD. You are holding yourself out as someone who will establish a fiduciary relationship with a client and will guard, to the best extent possible, those resources. To that extent, the certification requirements are the ones that have been raised.

Mr. MEYER. Yes. I would agree that that would be a good idea and the same sort of disclosure principles that presently exist under the Federal Investment Adviser Act in its brochure rule, which are really incorporated by the States into the new NASAA model amendments to the Uniform Securities Act, would certainly work.

Senator DODD. Mrs. McGrath.

Mrs. MCGRATH. Again, I think it would in the abstract, be a good idea, but I think it doesn't seem likely to happen.

Senator DODD. Not likely to happen.

Mrs. MCGRATH. Not likely to happen. You've got to deal with the exclusion for banks. So we have turned instead to looking at things that seemed more possible of achievement.

Senator DODD. Yes.

Mrs. MCGRATH. Working with the NASD. And I want to thank you, Senator, because you have really accomplished something. You got Frank here to agree that the NASD proposal could pick up affiliates of NASD member firms, and that is the first time I have heard that expansion of their offer.

Mr. WILSON. You misunderstood me. I said we would be willing to consider picking up affiliates.

Senator DODD. That's what I thought I heard you say, but you jumped ahead of my question. The best hearings are the ones where the witnesses start questioning each other.

The private right of action I mentioned earlier, do you agree with that?

Mr. MEYER. Absolutely. I think it is one of the most effective enforcement mechanisms that you could have.

Senator DODD. Increasing civil and criminal penalties?

Mr. MEYER. I would endorse those as well.

Senator DODD. Establishing financial responsibilities requirements for all financial planners? That falls back to that category again, and I realize I am being broad, in a sweeping broad here, but I want to get some response to it. You would have the same concerns you mentioned earlier?

Mr. MEYER. I have the same concerns I mentioned earlier, but I think it would be a desirable goal, if it could be achieved.

Senator DODD. Well, let me get one thing clear. Your objection, and your objection, Mrs. McGrath, is not that it is undesirable. You just don't think politically we could pull it off.

Mrs. MCGRATH. Right.

Mr. MEYER. That is right.

Senator DODD. But if you could establish and just use the word "financial planners" or people hold themselves out, whatever words they may use, then there should be these requirements.

Mrs. MCGRATH. Yes.

Senator DODD. It is the politics of it, not whether or not it is equitable.

Mr. MEYER. Right. If you were going to develop an ideal system, and you didn't have to worry about these political ingredients, all of the recommendations that you are making would be laudable and would be desirable to be implemented.

Senator DODD. OK. Mr. Wilson, I am going to jump in here and give you a chance to comment quickly. I should have asked you right along here, but how about these suggestions that have been made? What is your reaction to them?

Mr. WILSON. Suggestions relative to——

Senator DODD. These last four or five points that I have raised.

Mr. WILSON. Uniform disclosure system which would apply to all financial planners.

Senator DODD. Right. Certifications, and so forth.

Mr. WILSON. First, let me preface whatever I say about financial planners with the comment that we have very little, if any, experience in the financial planner area. Therefore, I can't speak from the standpoint of experience; however, speaking generally, and setting aside for the moment the political considerations which would attach to including all financial planners, such as reaching out to banks, insurance companies and so forth. Obviously, a single system is preferable than more than one system, as a general proposition, and it eliminates the possibility of duplicative regulation, redundant regulation, that kind of thing. So needless to say, we feel that that kind of regulation would be preferable; however, that does not mean to say that regulation of financial planners, investment advisers, at the State level should be ignored. We think the States serve a significant function in this area and can take action, significant actions, a lot more quickly sometimes than SRO's and even a lot more quickly sometimes than the SEC.

Senator DODD. I think most agree.

Mr. WILSON. But a single concept, it seems to me, is always preferable.

Senator DODD. I don't know if you were here earlier when the Commissioner from Maryland was testifying, but she made that point, and I think most agree with that. They are able to move much more quickly in many areas.

Mr. WILSON. I would agree with that.

Senator DODD. Let me come back to you, Mr. Meyer, if I can. We have heard a lot of testimony today and at other times that points to the financial planning industry as one that sort of targets the relatively well-to-do people, yet you have said that these services are now promoted to millions of other people who are of very modest means, going back earlier to Ms. Monseaux' testimony that here coplaintiffs in some cases were people who were of limited education, had worked blue collar jobs in many cases, were not certainly in the well-to-do category, as we generally understand it.

There is a certain amount of logic to that, but I wonder if you might expand further on why you are seeing this expansion of this community from the well-to-do to the more modest means. What is behind that, in your view?

Mr. MEYER. Well, I think over the course of the last several years there was phenomenal growth in the financial planning industry to begin with, dealing with middle income and upper income customers. This occurred during the time of an extraordinary bull market, the largest bull market we ever had in history, and there was a certain psychology, I think, that went along with the bull market where people developed expectations that they wanted to have the kind of returns that they heard about that were being made on Wall Street for themselves. We also saw a period of financial deregulation in this country with a plethora of new products being developed and a lot of average people just didn't know how to understand or measure or really decide how they could invest their money most profitably. This developed sort of a perceived need in large segments of the population, to anyone that had money that they needed financial planning advice.

I think all of these things contribute to the growth of financial planners who attracted money from blue collar workers and persons of more modest means than may have been clients in the past.

We have also seen another phenomenon occurring out of the market crash that's ironic, and that is, as a result of what happened on October 19 and the unprecedented ensuing market volatility. Many people have lost confidence in themselves to be able to make judgments over their own investment decisions and therefore have turned to financial planners and feel an even greater need to entrust their financial debts into one person who can give them the kind of help they need.

Senator DODD. Well, you have raised the question also and posed the issue of education, entry examinations, certain criteria that would reduce the number of people, obviously, who get into the business of being financial planners or investment advisers, and the assumption that one draws from that is that if you make this a bit more difficult to get into, you require different educational experience and backgrounds, that you are going to reduce the incidence of fraud and abuse. At least that is the conclusion. Is that

the conclusion that you have drawn or assumed on the basis of requiring those additional standards?

Mr. MEYER. That is correct. Any effective regulatory system must involve elements of prevention, detection and prosecution. You prevent people from committing fraud by establishing clear standards that one must meet in order to enter a profession. You detect violations by conducting inspections and by providing an investigative staff to respond to consumer complaints, and you prosecute people, both administratively, civilly and criminally, when they are found to have violated the law. The effect of those prosecutions is to serve a general deterrent effect on other people in the profession who might consider being a law breaker, and they also heighten consumer awareness of the fact that there is a regulatory system in place that they can rely upon.

Senator DODD. Well, I appreciate that, but there have been all sorts of studies done where other professions are involved and where educational criteria for people who are in the field have been proven to be really more of an exclusionary vehicle and have actually driven up prices, eliminated the number of providers and drive up prices.

RESPONSE TO OTHER STUDIES

How do you respond to those other studies? There have been a number done. The Federal Trade Commission has looked at a number of them over the years. In fact, the House committees in the past have examined those issues and discovered in many instances that actually the rationale behind the industry insisting upon higher educational standards is really more designed to keep people out as provides and the ultimate effect, of course, was to drive up prices. We want to encourage people to look at financial planners and investment advisers. They are going to need to do it. As I said in my opening statement, that is essential for an awful lot of people. They just can't, given the time constraints and so forth they are faced with.

So we don't want to be in the position where we are discouraging people from going into a field where that advice can be helpful, even to people of modest means who would like to make those decisions.

Don't we run the risk really of excluding people who might otherwise be good providers and really not deal, based on some earlier studies, effectively with the issue of dishonesty and fraud?

Mr. MEYER. Senator, I am not familiar with the studies that you are alluding to, but I can see the points that they make would be true in certain circumstances. Obviously, if you required a Ph.D. in economics for anyone who wanted to become an investment adviser, that would have the effect of narrowing the number of people who could enter that field unnecessarily, and it would really remove a very valuable service to the rest of our population, or else it would create a large segment of the population that was willfully violating the law.

Unfortunately right now that is what you have. You have large segments of the population that are actually functioning as investment advisers, financial planners, who either don't know that they

are supposed to register or know they are supposed to register and just ignore the law because at the State level, if you are required to register as an investment adviser, there are many statutory disqualifications that one has to negotiate in order to become registered. Even under the older State laws, there are abilities to deny an application for registration as an investment adviser, for example, if you are the subject of pending lawsuits or you have a history of securities law violations.

I think as Kathie McGrath has expressed previously, you can become a registered investment adviser with the SEC, even if you are an ax murderer. The felony that you must be convicted of under the statutory disqualifications in the Investment Adviser Act must relate to some investment-related business.

Senator DODD. Yes. Well, I appreciate your comments on that.

Mr. Wilson, you mentioned that since 1985 NASD has completed two studies dealing with financial planners and the regulation. Could you share with us briefly what those studies revealed?

Mr. WILSON. Well, the purpose of the first study was more of an internal type thing to evaluate from a general standpoint whether we should respond to inquiries from the SEC to even get involved in the financial planning area. As a result of that study, the board decided that before it could make a definitive conclusion, that the staff would have to make a more in-depth review to make a determination of how it would go about regulation in the financial planning area, what it would cost, what would be needed in terms of human and economic resources. As a result of that, in cooperation with Kathie's people, we embarked on a study which involved the field examination of some, I believe as it worked out, 45 or 46 firms, some of whom were NASD members, some of whom were not, who were engaged in the investment adviser business.

As part of the preparation for that, our examiners participated in a training program at the SEC and then a field on-the-job training program, so to speak, in which our examiners and the SEC examiners did a couple of examinations of investment advisers jointly. Thereafter, we conducted the other examinations that are referred to and reported that to the SEC. And part of that undertaking was to determine what it would cost the NASD to get involved in this area and the evaluations of that cost were made, based upon an estimate, obviously, assumptions of the number of examinations, first, the number of investment advisers that would be involved, the number of examinations, the kind of manpower it would take, and so forth, and made a report to the board. It was after that report was made that the board came to the conclusion that if requested, it would be willing to respond and become involved in the regulation of registered investment advisers of its members, of persons associated with members and of other entities which are made up of persons associated with members.

That is a resolution of the board that's attached to my printed statement.

Senator DODD. Thank you. I saw you come in. I don't know how much you have heard of the testimony, all of it this morning, but obviously, if you were sitting here and had to draft a question for yourself, the one that you would draft, I presume is the one I am about to pose to you, and that is, the one that we traditionally hear

about SRO's, the fox guarding the chicken coop notion here that obviously to have a self-regulatory organization is really not going to provide the kind of consumer protection that people are looking for, and also others have raised that it would link product sales and distribution with the delivery of objective financial planning and investment advice. One specific quote of a criticism. Yet at the same time, we have also heard that the SEC is limited in its resource capacity, States are limited in their resource capacity and not able to pursue it.

How do you answer? What is your response to those criticisms?

SELF-REGULATION

Mr. WILSON. Well, I think the fox in the chicken coop argument was first raised probably back before 1934 when the 1934 act was passed, and certainly, prior to 1938 when the Maloney Act was passed. And both of those initiatives on the part of Congress provided for self-regulation in the securities industry. Since that time, Congress has on several occasions evaluated whether, indeed, self-regulation works and has come to the conclusion each time that it does work and, indeed, has expanded the regulatory authority of the NASD and the exchanges over the years to include municipals, governments, as recently as 2 years ago, and so on.

So I think the argument of the fox in the chicken coop has largely been answered by history. I agree that—that legislation does not extend to the registered investment adviser area; however, it has worked in the securities industry, and I for one don't see any reason why it shouldn't work somewhere else.

Senator DODD. Yes.

Mr. WILSON. Especially when the concept of self-regulation has as an integral part of it very close oversight by the SEC, and presumably any concept of self-regulation that we are talking about here would involve a close oversight by the SEC and that negates the fox a little bit, I think.

Senator DODD. Mr. Meyer or Mrs. McGrath, do you want to comment on Mr. Wilson's answer?

Mr. MEYER. Yes, I think, generally, that self-regulation has been part and parcel and one of the reasons we have effective securities regulation in the United States. The crucial point that I would emphasize, however, is that self-regulation is not a substitute for governmental regulation, certainly not at the State level. Mr. Wilson emphasized that in developing proposals to regulate financial planners or investment advisers, we should stay away from duplicative regulatory schemes.

Under the present architecture of securities regulation we have in this country, the SEC registers securities and the States register securities. The SEC registers broker/dealers and the States register broker/dealers. The SEC registers investment advisers and the States register investment advisers. But the States do very different things than what the SEC does, indeed, do very different things from what the self-regulatory organizations do. So long as the fact of self-regulation is not used as some excuse as why the States should no longer feel that they have a regulatory interest in the matter, I think it is a concept that can be endorsed, certainly, with

the caveat that there needs to be aggressive SEC oversight over the conduct of any SRO.

Senator DODD. Yes.

Mr. WILSON. If I might, I would like to reemphasize that my statement emphasized that the States have a significant function in this and every other area of regulation and, indeed, States can reach people we can't reach as SRO's, and as I said earlier, they can, in many respects, move quickly. So in that context, we think that the States should be involved in regulation. We continue to be concerned about duplicative or redundant regulation, however.

Senator DODD. That is a very legitimate point, and I think we are all concerned about it as well.

Well, I thank all three of you again for being here. Ms. McGrath, we thank you for staying around for the second panel. Thank you, Mr. Meyer and Mr. Wilson.

Mr. WILSON. Thank you, Senator.

Mr. MEYER. Thank you.

Senator DODD. Our last panel, and they get the patience award, as we always give to the last panels, but we sometimes think it is helpful to hear others come before them, so they can get a chance to respond to some of the points that are made, are Larry Carroll, he is chairman, board of directors, International Association for Financial Planning from Atlanta, GA, where many of us spent a pleasant week, last week; Charles Hughes, the president of the Institute of Certified Financial Planners from Denver, CO; John Driskill, executive vice president of the American Society of CLU & ChFC of Bryn Mawr, PA. He will be accompanied by Burke Christensen, who is the vice president and general counsel of the American Society of CLU & ChFC.

We welcome all of you here this morning and hope, having the chance to sit and listen to others testify before you, that you have a chance to maybe modify some of your comments, respond to some of the things that have been raised earlier. We will accept your testimony in full, and so I would ask you to try and limit your comments to 5 or 7 minutes or so, in that range. So we don't tie you up, we will begin in the order that I have introduced you. Mr. Carroll.

STATEMENT OF LARRY CARROLL, CHAIRMAN, BOARD OF DIRECTORS, INTERNATIONAL ASSOCIATION FOR FINANCIAL PLANNING, ATLANTA, GA

Mr. CARROLL. On behalf of the International Association for Financial Planning, I would like to thank you and the members of the subcommittee for this opportunity to express the views of our 24,000 members, who represent all segments of the financial planning industry.

My name is Larry Carroll. I am president of Carroll Financial Planning Associates in Charlotte, NC. I am also privileged to serve as chairman of the board of directors of the International Association for Financial Planning, which is the group that expelled the member in Maryland, as was pointed out earlier.

My purpose today is to share with you and the other members of the committee the IAFP's view on the current status of the finan-

cial planning industry with particular emphasis on regulation of the industry.

Most financial planners practicing today began in traditional financial services industry segments. Most were once insurance agents, stockbrokers, bankers, lawyers or accountants. Many of the newer entrants are being training specifically for their responsibilities in the multifaceted personal financial planning area for individual clients. Many leading institutions in the brokerage community, insurance industry, accounting profession and banking now see financial planning as an opportunity to provide a needed service to consumers and are committing substantial resources to marketing that service. Consequently, financial planning continues to be a rapidly growing industry and is well-received by the consumer, and it is becoming a much more frequently requested professional service as compared to the past.

NO ENTRANCE REQUIREMENTS FOR FINANCIAL PLANNERS

While we believe that most financial planners are conscientious and do a good job for their clients, we are aware of instances in which the regulatory agencies have discovered some abuses in the industry. We are also aware of the NASAA report just released indicating the financial planner fraud and abuse increase between 1985 and 1988. Part of the problem, we believe, is the fact that there are no entrance requirements for people to get into the financial planning industry. Anyone can hang out a shingle calling himself or herself a financial planner and begin providing financial planning services to consumers.

While the SEC and State regulatory agencies do have regulatory jurisdiction over those financial planners who are investment advisers, budget and personnel limitations severely restrict the frequency and scope of such agencies' investigations and enforcement abilities. The SEC is able to inspect investment advisers only once every 11 years at this point. This is not satisfactory to achieve a desirable degree of compliance with the law.

Because this is such a rapidly growing industry and one which deals with an individual's life savings, the IAFP remains committed to the need for a self-regulatory organization for financial planners and investment advisers to ensure that qualified individuals are providing financial planning advice and to protect consumers from unqualified persons holding themselves out to be financial planners.

Since legislators, regulators and consumers perceive financial planners and investment advisers to be similar, it is only logical that a self-regulatory organization should encompass both groups.

The IAFP has advocated for several years a federally authorized self-regulatory organization for financial planners under the jurisdiction of the SEC. The board of directors recently amended our policy to include investment advisers in our proposal. We believe such an approach can be done economically and can provide the kind of self-regulation needed to protect consumers and ensure basic competency in the industry. The details of the IAFP proposal are contained in my written testimony, which I have submitted.

Senator DODD. It will be made a part of the record.

Mr. CARROLL. I feel that it is important to distinguish the IAFP's proposal from the pilot inspection program of the NASD, which is also commented on in the SEC staff's February 1988 report on financial planners, prepared at the request of the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance. The proposal by the IAFP would establish appropriate regulations to benefit the consumer in choosing and employing the services of those who recommend means to accomplish financial goals of the consumer. This involves a service and a process rather than the sale of a product. This difference in function and purpose of the investment adviser/financial planner from the product distribution function and purpose presents a fundamental difficulty with NASD's proposal to become a self-regulatory organization for investment advisers.

The SEC staff report found a somewhat core problem for consumers to be that often the adviser is also the implementor who earns commission on the sale of the products recommended. We concur with that analysis. The appearance and actual possibility of conflicts of interest are simply inherent in that arrangement like many other business situations, but like others, they are also controllable. We do not believe that such appearance or even possibility necessarily reflects reality nor that the arrangement should be or needs to be absolutely prohibited, rather how the relationship between the recommendation and product implementation are monitored, disclosed, and regulated is an important concept.

Simply put, the background, interest, philosophy, and training of the NASD product delivery side of the securities industry makes the NASD an inappropriate entity to perform SRO functions for investment advisers.

LIMITED COVERAGE

A second concern about the NASD serving as an SRO for investment advisers is the limited coverage which the NASD would give. The NASD coverage would include only investment advisers who are members of NASD firms, associated persons of NASD firms and entities whose personnel are associated persons of NASD firms. This is less than the universe to be covered, as it would omit accountants, bankers, and other financial advisers who are not registered with NASD firms but represent themselves as financial planners. The system will be ineffective if it leaves an area into which structuring of activities would avoid regulation.

One of our greatest concerns is that any regulation of financial planners should encompass all individuals who hold themselves out to be financial planners. Only the recently adopted Georgia legislation contains such a holding-out provision. This is crucial to effective regulation of the financial planning industry, because individuals who represent themselves to the consuming public as financial planners or using some other similar term should be required to register as investment advisers. This would meet our goal of providing effective and adequate consumer protection, while at the same time enhancing the profession.

We are aware of a perception in the public of fraud or abuse by financial planners which will only be enhanced by the NASAA

survey. We would remind the committee that the regulation and legislation we have advocated for more than 3 years would make it impossible for imposters to masquerade as financial planners perpetrating fraud on the public. Our association does not condone such misconduct and has taken action within the limitations of the antitrust laws to encourage the highest standards among our members. We have established a code of ethics and enforce it. We provide free to the public a financial planning bill of rights which shows consumers how to select a qualified financial planner. We also provide a consumer guide to financial planning which illustrates what is in a good financial plan and how to find a qualified planner.

We have established the Registry of Financial Planning Practitioners, the members of which must meet the highest standards of education and experience in the industry. They are also required to pass a test and the quality of their work is reviewed by a board of their peers.

We are doing what we can to improve the profession.

Further consumer protection can only be obtained through legislation such as the IAFP self-regulatory organization. The American people continue to rely heavily upon financial planners as the profession of choice and the individuals most qualified to manage their financial affairs. Financial planners far exceed the next recognized professional, accountants, as the individual of choice to manage a person's financial affairs.

While we are gratified at the degree of acceptance and satisfaction by the customers of financial planning professionals, we believe that for the industry to remain strong and to continue to retain the public's respect and confidence, it is important that the individuals who become financial planners be qualified and competent to carry out responsible tasks. It is for these reasons that it is important to take action now to ensure that the profession remains competent and that consumers' interests are protected.

It is for these reasons that we continue to recommend a federally sanctioned self-regulatory organization for financial planners and investment advisers. Thank you.

[The complete prepared statement of Larry Carroll follows:]

BE IT RESOLVED that:

The Board of Governors accepts the report of the pilot program Study Group and authorizes the NASD to proceed to take whatever action is necessary to establish the NASD as the self-regulatory organization for registered investment advisers subject to the following conditions:

1) The registered investment advisers who will be subject to the NASD's regulatory authority will only be those who (a) are members of the NASD, (b) are associated persons of NASD members and (c) are entities, not members of the NASD, whose personnel are associated persons of NASD members.

2) Investment advisory activities of registered investment advisers pursuant to investment management agreements with registered investment companies shall not be subject to NASD regulatory authority.

3) Amendments to the Federal Securities Laws that will be necessary to permit the NASD to become the self-regulatory organization for registered investment advisers shall, amongst other things necessary to the regulatory and disciplinary process, include authority for the NASD:

   a) to establish financial responsibility standards for registered investment advisers;

   b) to establish fees payable by registered investment advisers to defray the costs of regulation;

   c) To establish minimum experience, training, educational or other qualification standards for registered investment advisers, and

   d) to utilize the NASD's facilities for capturing and maintaining the registration records of registered investment advisers.

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TESTIMONY OF LARRY W. CARROLL, CPA, CFP,

CHAIRMAN OF THE INTERNATIONAL ASSOCIATION

FOR FINANCIAL PLANNING

BEFORE THE CONSUMERS AFFAIRS SUBCOMMITTEE

OF THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

JULY 22, 1988

WASHINGTON, D.C.

Mr. Chairman, on behalf of the International Association for Financial Planning, I would like to thank you and the members of the Subcommittee for this opportunity to express the views of our 24,000 members who represent all segments of the financial planning industry. My name is Larry Carroll and I am President of Carroll Financial Planning Associates in Charlotte, North Carolina. I am also privileged to serve as Chairman of the Board of Directors of the International Association for Financial Planning (IAFP). My purpose today is to share with you and other members of the Committee the IAFP's views on the current status of the financial planning industry, with particular emphasis on regulation of the industry.

You have asked us to address the following questions:

1. What are the most frequent kinds of abuses consumers face in dealing with financial planners, and how widespread are such abuses?
2. Is the current statutory scheme adequate to protect consumers against unscrupulous financial planners?
3. Do the inspections conducted by the SEC and state securities regulators effectively deter abusive practices?
4. What changes in law and/or regulations would you recommend to reduce consumer abuse in this area?

Before answering your specific questions, I would like to describe briefly the financial planning industry. Financial planning is a very complex process that involves the gathering of a wide array of financial information from a client, the development of financial goals and objectives for this individual and the creation of a plan which will allow that individual to achieve his or her financial objectives.

The financial planning process does not stop with the development of a plan. It is an on-going process, whereby a planner and his client continuously monitor progress toward the objectives of the plan and modify tactics and strategies as needed.

A professional financial planner is a generalist: that is, someone who has knowledge and skills in a wide range of financial services.

Financial planners are generally remunerated in one of three ways: "fee only" planners are paid for financial planning advice but do not sell financial products to their clients; "fee and commission" planners offer financial planning advice and also sell financial products; and a "commission only" planner's compensation may be limited to

commissions received on the sale of financial products. The majority of financial planners fall into the "fee and commission" category.

Most financial planners practicing today began in a traditional financial services industry segment. Most were once insurance agents, stockbrokers, bankers, lawyers or accountants. However, many of the newer entrants are being trained specifically for their responsibilities as multi-faceted personal financial planners for individual clients.

Many leading institutions in the brokerage community, insurance industry, accounting profession and banking now see financial planning as a new opportunity to provide a needed service to consumers, and are committing substantial resources to marketing that service. Consequently, financial planning is growing very rapidly, is well received by the consumer and is becoming a much more frequently requested professional service than ever before.

As expected, the added demand for financial planners has created the need for regulation by federal and state governments. The IAFP believes that providing a regulatory framework that protects the consumer of financial planning services is necessary and essential to the continued growth of the profession. That is why the IAFP has pursued a two-track approach to regulation: federal regulation in the form of an independent self-regulatory organization (SRO) under the auspices of the Securities and Exchange Commission, and

state regulation that is uniform and protects the consumer without stifling entry into the profession.

Although the Investment Advisors Act of 1940 does not specifically mention the term "financial planner", the SEC staff has issued its official interpretive opinion that most planners must register as investment advisers. This opinion, originally outlined in Release No. IA-770 in August, 1981, and updated in Release No. IA-1092 in October, 1987, clarifies the application of federal and state laws to financial planners and other persons who provide investment advice as a component of other financial services.

At the direction of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, the SEC made a report to that Subcommittee in February, 1988 entitled "Financial Planners". The report was in the form of a response to a number of questions, including who makes up the world of financial planners, who are the consumers of financial planning services, and is there a need for regulation of financial planning services. The report provides, for the first time, definitive information on the characteristics of financial planners who are registered investment advisers. It also provides a profile of typical consumers of financial planning services.

The staff report includes a section that deals with statistical information about investment advisers and their clients and another section on the National Association of

Securities Dealers' (NASD) pilot program of inspections of its members' adviser-related activities. The information in the survey is based on a general review of academic and industry literature; SEC in-house data obtained primarily from Form ADV, the investment advisers' registration form; information derived from the SEC's 1986 adviser inspection program; inspections of a random sample of 100 registered investment advisers; and a review of an NASD pilot program of investment adviser inspections. The IAFP also provided the SEC with the results of a 1987 survey conducted for us by Reichman Research of New York which assessed consumer attitudes toward their own financial situation and toward the financial planning profession.

There has been a dramatic increase in the number of advisers and planners in recent years, with the number of SEC registered advisers increasing from 5,445 in fiscal 1983 to an estimated 12,700 in fiscal 1988; this is an increase of approximately 18.5% a year. The SEC staff reviewed commission data on approximately 12,700 registered investment advisers and found that most advisers (85%) have individuals as clients; 58% advise pension or profit sharing plans; 54% advise corporations or business entities; 45% advise trusts, estates, or charities; 14% advise banks; and 13% advise investment companies. Most financial planners work alone or in small business organizations. The SEC staff found that most planning firms operate as sole proprietorships or small

corporations, with few organized partnerships. The number of clients a typical planner serves was difficult to count, with a 1986 SEC survey reporting an average of 33.4 clients per respondent, while an IAFP study showed an average of 175. Some 60% of financial planners work in areas with populations of over 500,000.

The report stated that fee-only planners are few, and that most planners derive a portion of their income from commissions on the sale of financial products. Data from one study, which was limited to small population centers, showed that 85% of respondents earned part of their income from commissions, 72% earned at least half from commissions, and 16% derived all of their income from commissions on product sales. Only 11% of the respondents reported earning over half of their income through fees.

While the SEC report contributes to the information base, it does not address one very significant issue: should financial planners be regulated? The IAFP remains committed to the need for a self-regulatory organization for financial planners and investment advisers to insure that qualified individuals are providing financial planning advice and to protect consumers from unqualified persons holding themselves out to be financial planners. Since legislators, regulators and consumers perceive financial planners and investment advisers to be similar, it is only logical that a self-regulatory organization should encompass both groups. As

early as 1985, the IAFP was urging Congress to hold hearings and consider legislation to create a financial planner SRO. The SEC study resulted from congressional hearings in the summer of 1986 called for by the IAFP.

The IAFP SRO proposal has as its objective the establishment of basic standards for those people involved in financial planning. The IAFP (which does not seek to be, or contemplate being, the SRO) has suggested the following as standards that might be adopted:

1. Education in financial planning;
2. Passage of an exam specifically designed to determine whether an individual understands the concept of personal financial planning;
3. Registration;
4. Mandatory continuing education for those involved in financial planning;
5. A code of ethical conduct;
6. An enforcement policy that would subject violators to fines, suspension from financial planning, or elimination of their right to ever be financial planners again; and
7. Field examinations of financial planning firms.

The SRO would be authorized by Congress and certain parameters would be established for the creation of an SRO by the SEC. This is quite similar to the legislation

authorizing the creation of the NASD and the National Futures Association.

The IAFP, in its efforts to suggest an SRO, recognized the prospect of substantial costs for the creation of such an organization and vigorous resistance from the industry if the cost were prohibitive. Therefore, we contemplated using existing systems within the regulatory framework to eliminate duplication of effort and to keep costs down. In fact, the present Central Registration Depository (CRD) system which is jointly owned by the NASD and the North American Securities Administrators Association (NASAA) as the method for uniform registration could be utilized. The PLATO testing system developed by the NASD may be appropriate for the SRO testing system, as well as some sort of joint venture on field examinations with the NASD and/or state securities offices. The idea is to create an SRO that would stand alone financially, without costing the participating companies or individuals a tremendous amount of money, and to use existing systems wherever possible.

The SRO is not envisioned to be a short-cut method to public acceptance of financial planning as a profession. Instead, its design is to meet consumers' need for protection from those people who are not properly trained and ethically motivated, yet call themselves personal financial planners. It is not to be anti-competitive or exclusive. In no way is it single-industry or product-minded

The IAFP Board of Directors in February, 1988 expanded the scope of the association's SRO proposal to include investment advisers as well as financial planners. The broadened scope of the IAFP proposal, plus the findings of the SEC study, are factors that should lead to more congressional hearings in both houses of Congress before the end of 1988. We do not expect any legislation to be considered in the near future because of both caution and concern in Congress generated by the volatility of the financial markets. We would argue, however, that this instability is causing consumers to look beyond traditional sources of financial and investment advice to financial planners. There is no reason to believe the growth in the financial planning profession (as documented by the SEC study) will not continue. Therefore, the IAFP continues to urge Congress to implement responsible regulation in the form of an independent SRO for investment advisers and financial planners.

Although the IAFP has been working on the SRO proposal for more than three years now, many states have not waited for the federal government to act. Some nineteen states have recently proposed legislation seeking to regulate financial planners in some way. The state activity is expected to increase and vary widely. In light of this, the IAFP Board of Directors in June, 1987 adopted a policy formalizing a second track to our position on regulation of the industry. The IAFP has been encouraging those states that feel

compelled to regulate financial planners to do so in the most uniform manner possible while also providing adequate protection for consumers of financial planning services.

The IAFP believes that the best method for state regulation of financial planners is for states to adopt the Uniform Securities Act of 1956 (USA) (if they have not already done so), and a set of model amendments to the USA proposed in 1986 by NASAA, plus some specific changes pertaining to financial planners. The NASAA model amendments would make changes to the investment adviser provisions of a state's securities code. The USA, approved in 1956 by the National Conference of Commissioners on Uniform State Laws, is a model act adopted by 39 states and the District of Columbia, in whole or in part and often with modifications. The USA definition of "investment adviser" conforms to that in the federal Investment Advisors Act of 1940. Both acts use the three-fold test to require registration: advice, business and compensation.

The NASAA model amendments to the investment adviser provisions of the USA would:

1. include financial planners in the definition of investment adviser if rendering advice on securities for a fee, or if holding oneself out as providing "total financial planning";

2. not include financial planners rendering advice exclusively in such non-securities areas as insurance;

3. require the registration of investment adviser representatives;

4. grant the securities administrator authority to establish minimum financial requirements, to require that information be delivered to clients comparable to the requirement of the SEC brochure rule, and to set competence and good character requirements, including testing.

The IAFP urges states to make the following changes in the NASAA model amendments:

1. define "financial planner";

2. include "financial planner" in the definition of investment adviser;

3. restrict exclusions for lawyers, accountants, bank employees, and others whose conduct of investment advisory services is solely incidental to the conduct of their business so that those holding themselves out as financial planners are not excluded from the registration requirements;

4. make it unlawful to hold out to the public as a financial planner unless registered as such (this is what we refer to as a "holding out" provision); and

5. provide for accommodation, subject to review by the state securities administrator, with an SRO when there is one.

The most crucial aspect of our proposal is the "holding out" provision. Simply stated, the IAFP feels that individuals who represent themselves to the consuming public as financial planners (or other similar term) or as providing financial planning services should be required to register as investment advisers. This provides effective and adequate consumer protection while at the same time enhancing the profession. The public is fast coming to expect a certain level of expertise and competence from those who call themselves financial planners, and yet the industry is limited in its ability to police itself.

In spite of increased interest in financial planner regulation by the states, there are still individuals practicing some form of self-styled financial planning today who are not fully competent, who have not been trained as financial planners, who are less than ethical in the conduct of their business, and who simply lack basic professional integrity. In many states, anyone can call himself or herself a financial planner and begin to practice as such. One may be registered as a securities salesperson or insurance agent if he sells those products, but with few formal requirements to register as a financial planner. We strongly encourage our members to register with the SEC as

investment advisers. However, the SEC does not have the resources to enforce the 1940 Act aggressively or effectively.

The result of this lack of enforceable regulation is that the public can easily be victimized by unscrupulous individuals holding themselves out to be financial planners, when in fact many have no training or credentials that would entitle them to the use of that term. In some cases the term "financial planning" is willfully being used to mislead the public and to perpetrate consumer fraud.

We are aware of a perception in the public of fraud or abuse by financial planners, but we would remind the Committee that the regulation and legislation we have advocated for more than three years would make it impossible for impostors to masquerade as financial planners. Our Association does not condone such misconduct and has taken action within the limitations of the anti-trust laws to encourage the highest standards among our members. We have established a code of ethics and enforce it. We provide free to the public a financial planning bill of rights which shows consumers how to select a qualified financial planner. We also provide a consumer guide to financial planning which illustrates what's in a good plan and how to find a qualified planner. We have established the Registry of Financial Planning Practitioners, the members of which have met the highest standards of education and experience in the

industry. We are doing what we can to improve the profession.

The International Association for Financial Planning is the oldest and largest organization representing financial planners in the world. We were formed in 1969 in Denver, Colorado, and moved our headquarters to Atlanta in 1975. Our organization has grown from 13 original organizers to 24,000 members in nineteen years.

Our growth in membership has been particularly rapid in the past several years. We have members in all 50 states and 22 foreign countries. There are 128 local chapters here in the United States.

The IAFP defines a financial planning professional as one who analyzes an individual's financial circumstances, consults with that individual to establish financial objectives and goals, makes written recommendations as to how those goals can be achieved, and provides on-going financial advice as those objectives are reached and as goals may be redefined due to changing individual circumstances.

The profile of a typical IAFP member is as follows:

- 81% are male, 19% are female;
- Average age is mid-forties;
- 43% of our members work in firms with 15 or fewer employees - most of our members are small businessmen;

Senator DODD. Thank you, Mr. Carroll, very much.
Mr. HUGHES. Welcome.

STATEMENT OF CHARLES HUGHES, PRESIDENT, INSTITUTE OF CERTIFIED FINANCIAL PLANNERS, DENVER CO

Mr. HUGHES. Thank you, Mr. Chairman, on behalf of the Institute of Certified Financial Planners, which is a national professional association located in Denver.

My name is Charlie Hughes. I am a practicing financial planner from Long Island, and I also serve as the president of the Institute of Certified Financial Planners.

We consider these discussions to be important not only to consumers and regulators but most especially to advisers who are the object of these discussions. Hopefully, we are drawing to that point in time where a decision to act, if it should be advisable, is approaching. And incidentally, we do think that some action is advisable at this time.

You have our complete testimony. I'd like to spend just a few minutes highlighting that testimony with a few pointed comments and recommendations.

By way of introduction, I would like to bring to your attention to two facts about the environment surrounding financial planning today. That is, the picture of financial planning as an outlaw industry perhaps is misguided. Financial scams have and will continue to occur, whether in the name of financial planning or some other descriptive. However, what is disturbing is that the basis of the relationship between a financial adviser and his or her client is that the client extends trust to the adviser and the adviser accepts that trust with a sense of fiduciary responsibility. That trust is undermined any time there is fraud or abuse, whether it is in the name of financial planning or some other activity. Therefore, we are as committed as you to root out all abuses which are occurring in the name of financial planning.

The second fact I would like to bring to your attention is that the term which is often used to describe the state of regulation with respect to financial planning, and that is loosely regulated, does not mean that financial planning is unregulated, but rather that regulation is often unevenly and inconsistently enforced. Virtually all elements or stages of the financial planning process are regulated by one jurisdiction or another; however, there is clearly some room for tightening existing regulation and in some cases suggesting a few enhancements to existing regulation.

I would like to briefly address the three questions you have posed to the panelists, the first dealing with abuses.

ABUSES

The most recent NASAA study has not uncovered any new news or new abuses with regard to financial planning. The number of abuses are greater, unfortunately, and the amount of money involved is also larger, but the focus is the same as it has always been, and that is the abuses are centered around product sales, unfortunately, in the name of financial planning; however, there gen-

erally have been and continue to be three principal abuses with respect to financial planning.

The first is a general noncompliance with the requirement to register or fully disclose on the part of those who otherwise do not enjoy an exemption from registration and full disclosure.

The second abuse deals with those individuals who lay claim to be financial planners, individuals who neither have the intention or the skills to provide the services the public is growing to expect from financial planners.

Third, those abuses which are centered on product sales.

The question then is, Is the current statutory structure adequate to address these three abuses I have identified?

Noncompliance with registration and full disclosure is clearly punishable under the current statutory structure.

With respect to those individuals who claim to be financial planners but are not, who use financial planning as nothing more than a guise to sell products, whether legitimately or illegitimately, is punishable as misrepresentation and fraud.

Finally, abuse of sales practices are clearly punishable under Federal law, self-regulatory organization regulations, and various State statutes.

The issue is not whether current statutory structure is adequate or not but rather is it now time to decide to do something about enforcing current legislation. In other words, is it time to get off the dime with a commitment to enforce and to do so in earnest?

With regard to your question about the effectiveness of inspections, we believe strongly that inspections serve as an effective preventative regulatory tool. Do they happen frequently enough? Unfortunately not. But is the infrequency of inspections reason to install a whole new regulatory structure? We believe that would be unfounded, unnecessary and costly; however, we do suggest some changes, and they deal with two areas: changes with regard to enforcement and changes with respect to enhancements to current legislation.

RECOMMENDATIONS

First, we would suggest more frequent inspections carried out in greater cooperation between the SEC and the States, particularly in sharing information uncovered through inspections and to inspect new registrants early in their careers.

Second, more funds should be earmarked for these inspections, with the fees based upon the size of the advisory firm.

Third, exempt small advisers from Federal jurisdiction and transfer the enforcement for current statutory requirements to the States.

Fourth, if these measures should prove to be ineffective, then authorize a third party to perform inspections only reporting to the states and the SEC.

Finally, fifth, to enforce current regulation with civil penalties for noncompliance, misrepresentation and fraud, leading to greater fines, prevention from practicing in the field and jail terms.

ENHANCEMENTS

With respect to the enhancements we recommend the following four enhancements:

No. 1, prepare a title functional definition for financial planner, requiring all who use the title or perform the services expected by the client to be registered and fully disclosed.

No. 2, encourage those States which do not have investment adviser statutes to adopt the NASAA Uniform Amendments to the Uniform Securities Act of 1956.

No. 3, if these measures should be ineffective, to encourage the states to take a lead from the voluntary professional certification institutions to establish minimum education and/or experience requirements as a means of maintaining confidence in financial planning but not as a measure to discourage entrance into the field.

No. 4, and perhaps most importantly, let consumers know what their rights are. Consumers have a right to accurate and current information about the adviser, by law. Consumers have a right to choose advisers who meed and exceed any minimum standards established through regulation.

Finally, consumers have a right to recourse if the trust they have placed in an adviser is violated by means of abuse or fraud.

Thank you, Mr. Chairman.

[Complete prepared statement of Charles Hughes follows:]

THE INSTITUTE OF CERTIFIED FINANCIAL PLANNERS

For More Information
Contact: Brent Neiser
(303) 751-7600

TESTIMONY
OF
CHARLES G. HUGHES, JR., CFP
PRESIDENT
INSTITUTE OF CERTIFIED FINANCIAL PLANNERS

BEFORE THE

CONSUMER AFFAIRS SUBCOMMITTEE
OF THE
U.S. SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

JULY 26, 1988

INTRODUCTION

The Institute of Certified Financial Planners is pleased to participate in this important hearing on the issue of financial planners. This written statement will directly address the four questions posed in Consumer Affairs Subcommittee Chairman Christopher J. Dodd's letter of July 6, 1988.

1. What are the most frequent kinds of abuses consumers face in dealing with financial planners, and how widespread are such abuses?

2. Is the current statutory scheme adequate to protect consumers against unscrupulous financial planners?

3. Do the inspections conducted by the SEC and state securities regulators effectively deter abusive practices?

4. What changes in law and/or regulations would you recommend to reduce consumer abuse in this area?

Additionally, we have included a copy of "Regulation Today" which graphically illustrates the existing structure and enhancements being considered for regulating financial planners and investment advisers. Regulation Today displays the relationship and scope of activity of the voluntary CFP professional certification program administered by the International Board of Standards and Practices for Certified Financial Planners (IBCFP) based in Englewood, Colorado.

Also included is an "Overview Of Existing Regulation of Financial Planners and Financial Planning Activities."

The Institute of Certified Financial Planners, headquartered in Denver, Colorado, is a national, non-profit membership organization that aspires to establish and maintain professionalism in financial planning, promote the continued advancement of knowledge in the financial planning field and to support programs increasing the abilities of Certified Financial Planner designees to serve their clients.

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the typical member has referred to himself as a financial planner for the past 5 years:

- 36% have been in practice for 10 or more years;
- 27% are certified financial planners;
- 18% are certified life underwriters;
- 11% are chartered financial consultants;
- 10% are certified public accountants;
- 6% are attorneys.

You may have read or heard recently about the results of the IAFP's second annual national opinion survey, "Americans Cope with Their Finances." The survey, conducted for the IAFP by Belchman Research, Inc. of New York and San Francisco, probes what is behind consumers' attitudes towards their finances and providers of financial services.

The survey found that high regard for financial planners continues, as consumers overwhelmingly select them as the financial professional of first choice. Across all income levels, Americans continue to name planners as the professional most qualified to manage financial affairs 37% more often than the next professional, accountants. Higher-income respondents and present users of financial professionals choose financial planners even more often than accountants (58% more often among higher-income, 72% more often among present users) and far ahead of stockbrokers, life insurance agents, bankers and attorneys.

When consumers were asked overall "who is the one professional who can do the best job of planning and budgeting," planners again came out on top over accountants by a 22% margin among the total public and by a 2 to 1 margin among higher-income people.

The gratifying aspect here is the ever-widening gap between the first-choice professional selected to manage financial affairs--financial planners--and the second-choice professional--accountants. Between 1987 and 1988 this gap increased 42% among the general public; 26% among the higher-income group.

When consumers were asked "who they actually choose as a financial professional," financial planners again come out ahead--way ahead--by a margin of more than 46% over the second choice. Ranking this year after financial planners are accountants (24%), stockbrokers (17%)--which dropped 43% from last year's second-place ranking--life insurance agents (15%), bankers (10%) and attorneys (4%).

To some, a surprising finding may be that planners did so well in a turbulent market of stock and bond crashes. Among a cross section of all Americans--even with incomes as low as $10,000--and among the higher-income group, overall usage of planners remained stable at 13% and 24%, respectively.

Use of financial planners among higher-income groups is greatest among those with household incomes of $80,000+

(32%), followed by $60,000 - $79,999 (22%) and $50,000-$59,999 (18%). Higher-income women use financial planners 38% more than higher-income men (29% women/21% men).

Among the higher-income age groups, use of financial planners is greatest in the 35-54 age group (29%), followed--interestingly---by the under-35 age group (23%).

Americans are turning to planners because people still are pessimistic about their long-term financial futures. In fact, the survey found that one-third of all Americans said "financial independence is impossible today."

When asked for their reason for seeking the services of a financial planner, more than half (58%) cite both "to improve financial position and to help reach future financial goals" as equally important reasons and over three-fourths (78%) of present users say the leading criteria for selecting a planner is "their ability to understand your needs and offer realistic alternatives."

Americans express even higher levels of consumer satisfaction this year. In fact, satisfaction with financial planner services is up 5% to a whopping 92% this year! At the same time, 87% of current financial planner users express satisfaction with the performance of their investments, while expressing a corresponding 70% decrease in dissatisfaction with services provided by a professional financial planner.

On the question of value, the vast majority of users (89%) say the services they receive are equal to or worth

more than what they are paying, with fully one-third saying they are "getting more than what they are paying for."

In conclusion, the IAFP believes that regulation of the financial planning profession should be enhanced through the implementation of a federal self-regulatory organization because of the growth of the industry and the increased demand and expectations of consumers. Current state and federal regulatory schemes are inadequate to protect consumers from abuses by those who call themselves financial planners while merely selling a product or propagating some scam on unsuspecting individuals. Although such abuses are not so widespread that a major threat exists, consumers should feel confident that they can trust their financial affairs to a true professional without fear of fraud or manipulation.

Again, the IAFP is grateful for this opportunity to offer comments to the Subcommittee on these important issues. We are ready to assist in any way necessary. Thank you.

1. ABUSES BY FINANCIAL PLANNERS

From rendering advice to implementation of a financial plan through products and strategies, nearly every function performed by a financial planner is currently regulated. (See attached Overview of Existing Regulations of Financial Planners and Financial Planning Activities). As a number of recent studies and hearings have pointed out, most abuses by financial planners appear to involve violations of existing laws related to product sales. Additionally, many individuals who call themselves financial planners are not registered as investment advisers because of exemptions. Although recent federal and state interpretations of the Investment Advisers Act of 1940 have clarified the applicability of investment adviser laws to financial planners. Financial planners who are registered investment advisers need to comply with the disclosure requirements or "brochure rule" of the Advisers Act which requires disclosure of conflicts of interest, methods of compensation, education, experience and disciplinary actions.

According to the February 1988 SEC Report on Financial Planners February, 1988, a profile of the typical financial planner client emerges as a person who, among other characteristics:

* is middle-aged
* is working in a business/professional area
* is reasonably well-educated
* has a relatively high income and net worth
* is seeking to plan for retirement or tax reduction

This client profile indicates, contrary to many press reports, that financial planning clients are capable of understanding financial planning and, if given proper disclosure as required by law, being prepared to make an informed decision about their choice of an adviser/planner.

Non-Registration/Non-Disclosure

SEC Release 1092 (adopted by NASAA) clarifies the applicability of the Investment Advisers Act of 1940 to financial planners. We see a number of encouraging signs that reflect trends for greater compliance. The indications we receive from our membership indicate they are finding it prudent and easier to register as investment advisers than to avoid registration or claim an exemption.

The Institute conducted a consumer survey in July 1987 that targeted subscribers to Sylvia Porter's Personal Finance magazine in order to question consumers who were more likely to have used or considered using the services of a financial planner. The consumer survey found that expectations of financial planners were overwhelmingly for investment advice (75%), tax planning (60%), and both general financial advice and retirement planning (56%). Also, the survey showed that 27% of the respondents received a full disclosure document when engaging a financial planner, and 74% felt it would be most helpful to them to have this full disclosure document before engaging a financial planner.

From this data, the Institute has drawn two general conclusions. The first is the public expects to receive investment advice when they engage a financial planner; therefore, in recognition of what the public expects, one who lays claim to being a financial planner - or functions as a financial planner - should register as an investment adviser and fully disclose to his/her clients. In light of this, it may be very difficult to support incidental exemptions from registration and full disclosure when one uses the title or performs the function of financial planner, since it is clear the public expects investment advice.

The publicity surrounding the recent SEC case in New Mexico where only verbal disclosure was presented has sent a clear signal to financial planners that advance, written disclosure is essential. Consumers should demand such disclosure and receive it before even contemplating doing business with a financial planner. It's the law and it's good business.

Product Sales

A number of studies of alleged abuses by financial planners have shown that violations occurred in conjunction with the sale or recommendation of a financial product. This area is clearly covered by existing law and enforcement should be actively pursued by those agencies charged with this duty.

The SEC staff has recently noted that the use of a term such as "financial planner" merely as a device to induce the sale of securities may be in violation of the anti-fraud provisions of the 1933 and 1934 Securities Acts.

BIOGRAPHY

Charles G. Hughes, Jr., CFP
President

Charles G. Hughes, Jr., CFP, is president of the Institute of Certified Financial Planners.

Hughes, a nationally recognized leader in the financial planning profession, has been active in the financial services industry for over 15 years after serving in higher education as an instructor in classical languages and an administrator. He has an undergraduate degree in philosophy, and two graduate degrees from the State University of New York in theology and religious education.

Hughes received his Certified Financial Planner™ designation in 1979 from the College for Financial Planning. Active in financial education, he has served on the adjunct faculties of the College for Financial Planning, New York University, College of Mt. St. Vincent, and the Center for Financial Studies at Fairfield University.

An author, speaker and resource on financial management and planning topics, Hughes has appeared on both cable and network TV, and hosted the popular Bill Bresnan financial show, aired on WABC Talk Radio, New York. He's been featured and quoted in *Money*, *Sylvia Porter's Personal Finance*, *USA Today*, *New York Times* and *Wall Street Journal*. His articles have appeared in *American Banker* and the professional *Journal of the Institute of Certified Financial Planners*.

Hughes has served on the Institute Board since 1981 and as a member of its Executive Committee since 1984. Involved with important issues confronting the profession, he has chaired the Institute's Regulatory Committee for three years, represented the association and the profession in hearings before the Securities and Exchange Commission, the U.S. Congressional Subcommittee on Telecommunications, Consumer Protection and Finance, and various state legislative and regulatory commissions.

Listed in *Who's Who in Finance and Industry*, Hughes is an elected Trustee and Fiscal Officer for the Incorporated Village of Brightwaters, New York, where he resides. C.G. Hughes Company, the firm he founded in 1981, is a registered investment adviser, providing financial and investment counseling, management and planning services to individuals.

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THE INSTITUTE OF CERTIFIED FINANCIAL PLANNERS

Overview:
Existing Regulation of Financial Planners and Financial Planning Activities

I. Registered Investment Adviser Laws

Federal Investment Advisers Act of 1940:
(Administered by the Securities and Exchange Commission)

- Fiduciary Standard of Care
- Registration Using Uniform Forms
- Disclosure (Conflicts of Interest, Methods of Compensation, Education, Experience, Financial and Disciplinary Information)
- Inspections
- Strong Penalties
- Cooperation with State Agencies

***State Investment Adviser Laws:**
(Administered by state securities agencies)

- Reflects Many Features of the Federal Law
- †• Computerized Registration and Tracking (NASAA/NASD Central Registration Depository)
- †• Registration of Investment Adviser Representatives
- †• Uniform Adviser Examinations
- †• Uniform Rules
- Cooperation with SEC

*Thirty-nine states currently have investment adviser laws. Some of those states are enhancing those laws and others are adopting broad-based interpretations of their applicability to financial planners. Many states that do not have investment adviser laws are actively considering their adoption.

†Contained in the NASAA Amendments to the Uniform Securities Act of 1956

II. Existing Regulation Governing Transactions/Advice

- Securities Transactions (SROs, Federal, State)
- Insurance Transactions (State)
- Insurance Advice (State)
- Real Estate Transactions (State)
- Debt Adjusting (State)

III. Voluntary Professional Certification (for example):

Certified Financial Planner™

- Education (Approved body of knowledge)
- Comprehensive Testing
- Experience Requirement
- Continuing Education Requirement
- Enforcement of Ethical Standards (Persons holding CFP® are subject to sanctions imposed by the International Board of Standards and Practices for Certified Financial Planners, Inc. including prohibiting the use of the CFP mark)

IV. Other Public Protection:

- Anti-fraud Statutes (Federal and State)
- Lawsuits
- Consumer Protection Agencies (State)
- Non-profit Consumer and Financial Planning Associations (for example, Better Business Bureaus, the Institute of Certified Financial Planners, etc.)

Institute of Certified Financial Planners 9/87

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Institute of Certified Financial Planners

Regulation Today

REGISTRATION DISCLOSURE ENFORCEMENT

Regulation Today features a model that depicts the financial planning regulatory environment based on the Institute's views. We hope that as you read and analyze the following, you will develop a clearer, more comprehensive understanding of the various components that comprise the Institute's position, which is best summarized in three words: Registration, Disclosure and Enforcement.

The Institute believes that the foundation for regulating financial planners is an active, informed consumer with the financial planner being the agent of the client and acting in the client's best interests as a fiduciary. The Institute's position parallels much of the thrust of the Consumer Federation of America's recent recommendations for dealing with financial planners' alleged abuses of consumers. Consumer protection can be accomplished through the enhancement of existing investment adviser (IA) laws and the availability of voluntary professional certification, such as offered by the International Board of Standards and Practices for Certified Financial Planners, Inc. (IBCFP) with its CFP® recipient program.

In July of 1987, the Institute commissioned a survey of 5,000 subscribers to Sylvia Porter's *Personal Finance* magazine. The results indicated that respondents expect to receive investment advice when engaging the services of a financial planner and rated this service-advice expectation higher than 6 of 7 other expectation of financial planner services. This result confirms that investment advice is considered an integral component of the financial planning process. Because those who deliver advice about securities for compensation must register as investment advisers, the Institute believes that those who hold themselves out as financial planners (and imply the capability to provide investment advice), should be Registered Investment Advisers (RIAs), and the public should be encouraged to seek services from financial planners who are RIAs in order to be afforded protection by the basic level of financial planner regulation.

Additionally, new disclosure requirements contained in Rule 206(4)-4 have been addressed in the Commission's Release No. IA-1083. The adoption of this rule mandates RIAs to disclose whether advisers have been the subject of certain types of disciplinary action, and, when applicable, and are in a "precarious financial condition". The aforementioned consumer survey also indicated that 74% of the respondents felt that it would be very helpful to receive a disclosure document before hiring a financial planner. These enhancements to the disclosure requirements, (already are more stringent than for any other profession), will further enable the client to make the most informed decision possible.

The Institute sees evidence that the North American Securities Administrators Association's (NASAA) Investment Adviser Amendments to the Uniform Securities Act of 1956 (NASAA's uniform amendments) are widely being considered as a model by the approximately forty states that currently have, and are enhancing, investment adviser laws. We also advocate this activity for states that do not have IA laws in place and are considering their adoption. Additionally, it is anticipated that further cooperation between federal and state securities agencies will bring about uniform disclosure, examination, enforcement and registration (through the Central Registration Depository possibly with a one-time filing of Form ADV) requirements. This move toward uniform requirements will ease the registration process and facilitate interstate registration for investment advisers who have clients in many states. In terms of enhancing enforcement of these laws, the Institute would not be opposed to delegating inspection authority to qualified third parties, where necessary, to encourage uniform, timely inspections.

Although the Institute recognizes the existence of other designations, such as J.D., ChFC, CPA, and CFA, our model's representation of the merits of voluntary certification focuses on the CFP mark, which is widely recognized by the public as the "mainstream" designation of financial planning professionals and is becoming synonymous with the practice of financial planning. There is a particular unique quality to some of the IBCFP's certification requirements. For instance, education and comprehensive testing are supplemented with continuing education requirements to assure ongoing quality of the CFP recipient's level of education. Four benefits to the consumer are the CFP recipient's adherence to: Education, Examination, Experience and Ethics standards.

The purpose of all elements that comprise regulation is to assure that recipients of financial planning services are well protected and competently advised. Consumers must feel that those to whom they turn for advice are required to adhere to the law (registration), they have been provided with everything necessary to make an informed decision about their choice in advisers (disclosure), they can receive competent advice based on their individual and specific needs (voluntary certification), their interests are being placed above those of their advisers (adviser's fiduciary responsibility) and they can feel confident of their ability to seek recourse if deprived of these elements (enforcement).

Additionally, consumers need to be educated about what to expect from the financial planning relationship (clients' needs vary, and so will the form of advice and method of delivery), how to recognize one who will be able to fulfill those expectations (deciphering what services the adviser is capable of and actually will deliver based on how the individual holds him or herself out to the public) and how to recognize which advisers have elected to aspire to the highest set of standards applicable to financial planners.

Other Issues

The Institute believes that financial planner legislative initiatives should be made within the context of investment adviser laws and opposes any additional layer of regulation as it would be extremely difficult and expensive to justify the need for new layers of requirements at this time.

Other concerns include:

- government regulating, for the first time in an advisory profession (customarily regulated by ethical, experience and education standards), the process of rendering financial planning and investment advice;
- increasing compliance costs with new regulatory layers that would reduce the affordability of financial planning;
- anti-competitive climate for the profession;
- reducing the public's active role in selecting, engaging, evaluating and ultimately regulating financial planners through disclosure;
- replacing methodologies arising from professionals and academics with those imposed by outside forces;
- equating (and limiting the perception of) the function of a financial planner with securities sales by establishing the SRO that regulates securities sales as the regulatory body for those who deliver investment advice.

Summary:

The basic components for adequate financial planner regulation are in place. Additionally, regulation exists that governs financial planners' transactions/advice. Securities, real estate, debt adjusting and insurance (including advice) transactions are governed by state law. Transactions involving securities are also overseen by Self-Regulatory Organizations (SROs) and federal law.

The opportunity for financial planners to voluntarily submit to certification requirements also contributes to an environment that suggests the highest possible level of proficiency. An educated, informed consumer will also serve as regulator as he or she recognizes and chooses advisers who comply with applicable requirements and higher standards of care rather than those who do not.

For More Information On:

- *how to register as an investment adviser* at the federal level, contact the Securities and Exchange Commission, Public Reference Branch, 450 Fifth Street, N.W., Washington, D.C. 20549 (202) 272-7450.
- *how to order the SEC's IA Release No. 1092* (the IA Act of 1940's applicability to financial planners) or 1083 (new disclosure requirements) contact the SECs, Public Reference Branch, 450 Fifth Street, N.W., Washington, D.C. 20549 (202) 272-7450.
- *how to register as an investment adviser* at the state level, contact your state's securities agency (usually located in the state's capital).
- *the CFP recipient program*, contact the IBCFP, 5445 DTC Parkway, Suite P-1, Englewood, CO 80010 (303) 850-0333.
- *questions or concerns about regulation*, contact the Government Affairs Department at the Institute of Certified Financial Planners, 10065 E. Harvard Ave., Suite 320, Denver, CO 80231-5942 (303) 751-7600.

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Senator DODD. Thank you, Mr. Hughes.

Mr. DRISKILL. I have never seen "Driskill" spelled that way.

Mr. DRISKILL. Right, Mr. Dodd. I am a member of a minority group when it comes to "Driskills." [Laughter.]

STATEMENT OF JOHN R. DRISKILL, EXECUTIVE VICE PRESIDENT, AMERICAN SOCIETY OF CLU & ChFC, ACCOMPANIED BY BURKE A. CHRISTENSEN, GENERAL COUNSEL

Mr. DRISKILL. Mr. Chairman, the American Society of CLU & ChFC is pleased to have this opportunity to present its views on the regulation of financial planning.

My name is John R. Driskill, spelled with a k-i-l-l, and I am the executive vice president and the managing director of the American Society.

For purposes of clarification, let me explain our name, briefly. The initials "CLU" stands for Chartered Life Underwriter and the initials "ChFC" stands for Chartered Financial Consultant.

As written, my testimony fully explains both of these terms and the professional designations that they represent and indicates that the holder of these designations has completed an advanced course of study covering both insurance and financial services.

The core of the American Society's position with respect to the regulation of financial planners can be stated quite clearly: State and Federal regulation of financial planners which takes the form of registration requirements, entrance exams for licensing purposes, or which restricts the use of the title "financial planner" to any select group will not protect the public from unscrupulous or incompetent financial planners.

Since there is no form of preventative regulation which will protect anyone against those who intend to break the law, we recommend that any government efforts should be focused upon giving the consumer the tools of his and her own protection by continuing to enforce conflict of interest disclosure.

Last, since no form of government licensure based upon an entrance exam and no form of registration or inspection can protect against incompetency, we recommend that the Government act to encourage continuing education for practitioners.

The preceding statements are based upon the following four ideas:

First, that threshold entrance exams which test for minimum levels of knowledge as a condition of entrance into an occupation cannot guarantee competence, even at the time of examination itself, especially in an area as complex as financial planning.

Second, an entrance examination cannot guarantee that the successful examinee will remain competent throughout the working years of that individual beyond that examination.

Third, disclosure of a financial planners' education, business practices, background and experience is important, but mandatory disclosure of the financial planner's conflicts of interest with his or her client is a better form of control than exams or background disclosure.

Fourth, regular participation in continuing education programs is the best method to assure competence. Therefore, government participation should be designed to ensure such ongoing education.

HISTORY OF SOCIETY

Let me give you a brief history of the American Society or explain why we are interested in financial planner regulation. The American Society of CLU and ChFC was organized in 1928 and now numbers over 32,000 members who represent all the major financial service disciplines from law to life insurance. Virtually all of our members hold the Chartered Life Underwriter designation and more than 17,000 individuals now hold the Chartered Financial Consultant designation as well.

The Society's membership is organized into 230 chapters located in all 50 States, the District of Columbia, Canada, and Puerto Rico. The membership is served by a professional staff of 50 employees from Society headquarters in Bryn Mawr, PA.

But most importantly, membership in the American Society requires adherence to the Society's published code of ethics. A violation of the code would expose a member to sanctions which range from reprimand and censure to suspension or even revocation of membership in the Society.

The heart of the code of ethics is the principle that a member must always provide advice and service which are in the best interests of the client. Therefore, the code requires that in a conflict of interest situation, the interests of the client must be paramount.

The American Society is a 61-year-old organization which has historically devoted the majority of its interests to the continuing education of its members. To support this long-term commitment, the American College, the American Society have recently announced the formation of a formalized continuing education program for all holders of the CLU and ChFC designations.

The Society asserts that adequate laws to regulate financial planners who provide investment advice are now available under the provisions of Federal security laws such as the Investment Advisers Act of 1940. The State versions of the Uniform Security Acts of 1956 provide additional local control. In addition, there are adequate laws which currently control financial planners who sell products such as insurance, securities, and real estate at both the State and the Federal levels.

We fully support regulation and registration of those financial planners who act as investment advisers under the appropriate State and Federals laws, and we have taken measures to encourage our members who provide such services to register with these regulatory bodies; however, it is vitally important to distinguish between regulation of financial planners as investment advisers and regulation of financial planners as a separate occupation.

The Society does not support Federal or State regulation of financial planners as a separate profession or industry, because in our opinion no such distinct profession or industry exists. This view is consistent with the SEC Investment Adviser Release No. 1092, which imposes regulation on financial planners only when they act as investment advisers.

We believe that financial planning is a generic term which refers to many types of financial services. A financial planner who sells insurance should be regulated as an insurance agent. A financial planner who sells securities or one who sells security advice should be regulated by the State and Federal security laws. A financial planner who is not already regulated by one or more of these sets of laws does not exist.

We assert that publicized abuses have not been the result of inadequate law or insufficient regulation. The abuses are already violations of existing laws. Additional law and regulation will not prevent unscrupulous people from being dishonest but will merely add to the cost of financial advice at the hands of the consumer.

Therefore, we believe that full disclosure is the most effective means to enable consumers to select competent counsel from among the many people who offer financial planning services. Such disclosure requirements already exist in the State and Federal security laws and in many State codes. These State insurance laws prohibit an insurance agent from using terms like financial planner to imply that the agent receives compensation which is unrelated to sales unless such is actually the case. So in keeping with this philosophy, we believe that full disclosure is proper for all. Thank you very much.

[Complete prepared statement of John R. Driskill follows:]

II. ADEQUACY OF CURRENT REGULATORY STRUCTURE

State and federal hearings, reported violations of law, numerous studies and consumer surveys as well as legislative and regulatory action on the state level have pointed to present federal investment adviser regulation as an adequate foundation for the regulation of financial planners/investment advisers. This is best embodied in the NASAA amendments to the Uniform Securities Act of 1956 and the other federal/state enhancements such as Form ADV, Release 1092, Central Registration Depository, joint training of inspectors and coordination of inspections.

Additionally, standards for education, experience, ethics and financial requirements for financial planners and investment advisers have already been put in place by professional standard setting organizations such as the International Board of Standards and Practices for Certified Financial Planners (IBCFP) or many states respectively. Current disclosure rules effectively bring many of these requirements and voluntary professional certification programs to the attention of consumers.

The Institute and the IBCFP are taking steps to promote and add value to the CFP designation so that consumers will be able to recognize the CFP mark as the single designation that embodies ethics/enforcement, testing, continuing education and experience. The IBCFP will be able to take the initiative to provide comprehensive disciplinary and standard setting coverage for CFP designees that government agencies are not equipped to handle. As the February, 1988 SEC Report on Financial Planners states, "the CFP designation appears to be developing as the most recognized designation in the planning field."

It is inappropriate for the NASD to take on the role outlined in their proposal because it would link product sales and distribution with the delivery of objective financial planning and investment advice. Under the NASD proposal, the current investment adviser community would be fragmented, (NASD members and affiliates versus non-NASD members and affiliates) thus increasing consumer confusion.

As financial planner and investment adviser regulation has been studied and debated for the past five years, nothing has changed to warrant embracing an initiative such as the NASD proposal.

III. INSPECTIONS

The fundamental problem that has given rise to the proposal that the NASD serve as the self-regulatory organization for investment advisers appears to be in the area of inspections, although the SEC staff has made outstanding progress in targeting high risk and new registrants and increasing the number of inspections performed as well as sharing information with states and training state inspectors.

Inspections are useful in two varieties. First is an initial compliance inspection for newly registered investment advisers so they can be sure of having the proper procedures in place for disclosure, record-keeping, advertising, etc. Surprise and routine inspections can also be useful because inattention to the requirements of investment adviser laws can frequently be a sign of trouble. According to the SEC Report on Financial Planners, the majority of financial planners' deficiencies are handled through deficiency letters or on-site corrective action. The number of complaints against investment advisers "is still a small percentage of overall complaints" and appears to have been consistent over the last few years. Routine inspections are the origin for only 16% of the SEC investment adviser enforcement actions, notes to the SEC report.

More significant than inspections is the involvement of the consumer as an active regulator of financial planners through the receipt of comprehensive disclosure documents. This can be accomplished through additional consumer education.

IV. RECOMMENDATIONS FOR CHANGE

Registration/Disclosure

- The SEC should go further than IA Release No. 1092 and require all who hold themselves out to the public as financial planners to register as investment advisers. This change could be implemented immediately without the need for legislation. Once this is done, states will generally follow this interpretation for their own investment adviser laws.

- The NASAA Investment Adviser Amendments to the Uniform Securities Act of 1956 should be passed in all states. (Investment adviser laws now exist in approximately 40% of the states.)

- Civil penalties for non-registration and non-disclosure should be raised. (The publicity associated with such sanctions should yield more widespread compliance than could be achieved through inspections alone.)

- Individuals or firms who do not use terms that properly represent their activities should be viewed as violating antifraud statutes.

Inspections

- Authority should be delegated to qualified third parties to conduct "inspections only." This will reduce the burden on the SEC staff, while it continues to function in an inspection training and oversight role.

- The SEC should collect reasonable, annual fees based on the registered investment adviser's amount of assets under management or number of advisory employees. (For example, an annual fee paid by a three person advisory firm should be significantly less than the fee paid by a large national advisory firm.)

- Smaller advisory firms that do not have custody of or discretionary authority over client funds or securities should be exempt from federal law and registered with the states.

Product Sales Abuse

- As is the case in the NASAA Uniform Amendments, broker/dealers should be held fully responsible for the activities of associated investment advisers.

- The NASD already has the authority to monitor and regulate registered representatives in their sales capacities if they are investment advisers or financial planners. Many problems with investment advisers and financial planners stem from sales activities not performed out of a home office. Under its current authority the NASD should focus on this area through inspections and reviews of full disclosure compliance.

CONCLUSION

Financial planning is an individualized process. In some cases, plans are not prepared in writing. This connotes a client/adviser relationship that is driven by consumer needs and circumstances, and is consistent with meeting a fiduciary standard of care. The current structure of investment adviser law permits such a professional relationship.

From the investment adviser's and financial planner's perspective, there is now a recognition of the increased liability in using the descriptive term "financial planning," and performing the services of financial planning because the underlying basis of the relationship between client and adviser is fiduciary-driven. This liability arises more so from providing investment advice than any other component of financial planning. In fact, insurance companies recognize this risk in liability. Errors & Ommissions (E&O) coverage is difficult to find and is expensive. The coverage often contains exclusions. Some brokerage firms are discouraging and, in fact, prohibiting the use of the Certified Financial Planner designation on registered representative's business cards unless, in fact, they perform the services of a financial planner.

The planning profession is maturing and we feel that planners can best assure continued progress in this direction through compliance with existing laws (registration), heightened consumer awareness (disclosure) and opportunity for voluntary professional certification (professional education, testing, continuing education, ethics). It appears that financial planning professional organizations and those granting designations are playing vital roles in the public/private partnership that is emerging in the regulation of financial planners.

UNITED STATES SENATE

HEARINGS ON

REGULATION OF FINANCIAL PLANNING

before the

CONSUMER AFFAIRS SUBCOMMITTEE

of the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Testimony of

THE AMERICAN SOCIETY OF CLU & ChFC

John R. Driskill, CLU, ChFC
Executive Vice President

Burke A. Christensen, JD, CLU
General Counsel

JULY 26, 1989

Room SD 538
Dirksen Senate Building
Washington, D.C.

The American Society of CLU & ChFC is pleased to have the opportunity to present its views on the regulation of financial planning. My name is John Driskill. I am Executive Vice President and Managing Director of the Society.

The core of the American Society's position can be stated quite clearly:

1. State or federal regulation of financial planners which takes the form of registration requirements, entrance exams for licensing purposes, or which restricts the use of the title "financial planner" to any select group will not protect the public from unscrupulous or incompetent financial planners.

2. Since there is no form of preventive regulation which will protect anyone against those who intend to break the law, we recommend that any governmental efforts should be focused upon giving the consumer the tools of his or her own protection by mandating conflict of interest disclosure.

3. Since no form of governmental licensure based upon an entrance exam and no form of registration or inspection can protect against incompetence, we recommend that government act to encourage continuing education.

The preceding statements are based upon the following ideas:

1. Threshold entrance exams which test for minimum levels of knowledge as a condition of entrance into an occupation cannot guarantee competence, even at the time of the exam, in an area as complex as financial planning.

2. An entrance exam cannot guarantee that the successful examinee will remain competent in the years which follow the exam.

3. Disclosure of a financial planner's education, business practices, background and experience is important, but mandatory disclosure of a financial planner's conflicts of interest with his or her client is a better form of control than entrance exams or background disclosure.

4. Regular participation in continuing education programs is the best method to assure competence. Governmental participation should be designed to encourage continuing education.

I. History of the American Society

The American Society of CLU & ChFC was organized in 1928 and now numbers over 32,000 members who represent all the major financial services disciplines from law to life insurance.

Virtually all of our members hold the Chartered Life Underwriter (CLU) designation and more than 14,000 of the Society's members hold the professional designation Chartered Financial Consultant (ChFC). The Society's membership is organized into 230 chapters located in all 50 states, the District of Columbia, Canada and Puerto Rico. The membership is served by a professional staff of 50 employees from Society headquarters in Bryn Mawr, Pennsylvania.

A. Membership Requirements

Membership in the Society may be attained upon completion of a ten-course curriculum of study offered by The American College, a fully accredited, degree granting educational institution whose campus is located in Bryn Mawr, Pennsylvania. The College was founded in 1927 on the campus of the University of Pennsylvania in Philadelphia.

Depending upon the classes selected by the student, the prescribed course of study leads to the Chartered Life Underwriter (CLU) or Chartered Financial Consultant (ChFC) designation and generally takes four years to complete. CLU students can elect to concentrate on life and health insurance or personal insurance. The College's CLU and ChFC course offerings are listed in Appendix A.

In addition, a candidate for either designation must show proof of three years' experience related to financial services. Finally, candidates for each designation must pass a review of their ethical conduct. Deficiencies can lead to the withholding of a designation or to its subsequent withdrawal.

The American College also offers a Masters Degree in Financial Service (MSFS). Holders of this graduate educational degree are eligible for membership in the Society. Limited Society student membership privileges are granted to those enrolled in the courses leading to the CLU and ChFC designations or the MSFS degree.

B. Ethical Requirements of the American Society

Membership in the American Society requires adherence to the Society's published Code of Ethics. A violation of the Code would expose a member to sanctions which range from reprimand and censure to suspension or revocation of membership in the Society.

At the heart of the Code of Ethics is the principle that a member must always provide advice and service which are in the best interests of the client. In a conflict of interest situation, the interests of the client must be paramount. That principle is reflected in the Professional Pledge which is taken by every member of the Society.

The Pledge states: "In all my professional relationships, I pledge myself to the following rule of ethical conduct: I shall, in light of all conditions surrounding those I serve, which I shall make every conscientious effort to ascertain and understand, render that service which, in the same circumstances, I would apply to myself."

C. Commitment to Continuing Education

The American Society is a 61-year-old organization which has historically devoted the majority of its interest to the continuing education of its members. To support this long-term commitment, The American College and the American Society have recently announced the creation of a formalized Continuing Education Program for all holders of the CLU and ChFC designations.

II. Regulation of Financial Planners

The American Society and its members have a direct interest in the regulation of financial planners, because such regulation will directly affect those of our members who provide the regulated financial planning services. It will indirectly affect those members who conduct their business in other areas of financial planning. The balance of our membership will be affected in proportion to the impact of a new layer of regulation on the efficient distribution of life insurance products and services.

The Society avers that adequate laws to regulate financial planners who provide investment advice are now available under the provisions of federal securities laws such as the Investment Advisers Act of 1940. The state versions of the Uniform Securities Act of 1956 (USA '56) provide additional local control. In addition, there are adequate laws which currently control the financial planners who sell products, such as insurance and securities, at both the state and federal level.

We fully support regulation and registration of those financial planners who act as investment advisers under the appropriate state and federal laws and we have taken measures to encourage our members who provide such services to register. However, it is vitally important to distinguish between regulation of financial planners as investment advisers and regulation of financial planners as a separate occupation.

The Society does not support federal or state regulation of the term "financial planner" because the term has no accepted definition. The Society does not support federal or state regulation of financial planners as a separate profession or industry because no such distinct profession or industry exists. On this point, it is instructive that the NASAA amendments to the Uniform Securities Act of 1956 and that two SEC Investment Adviser Releases (IA 770 and IA 1092) under the

Investment Advisers Act of 1940 impose regulation on financial planners when they act as investment advisers and not as a separate occupation.

We believe that financial planning is a generic term which refers to many types of financial services. All of these services; such as banking, insurance, securities, law, and accounting, are already regulated. When a financial planner performs the tasks associated with any of those professions or occupations, he or she is, and should be, subject to the laws regulating that business. A financial planner who sells insurance should be regulated as an insurance agent. A financial planner who sells securities, or one who sells securities advice, should be regulated by the state and federal securities laws. A financial planner who is really an attorney or an accountant should be regulated by those professions. A financial planner who is not already regulated by one or more of these sets of laws does not exist.

The addition of new regulation which tries to focus only upon financial planners is unwise, unnecessary and unresponsive. Instead of being made subject to newly enacted catchall financial planner laws, we believe that financial planners who provide investment advisory services should be required to disclose potential conflicts of interest and their financial background as required of any investment adviser by the "brochure rule" of the Investment Advisers Act of 1940.

The Society asserts that the publicized abuses have not been the result of inadequate laws or insufficient regulation. The abuses were already violations of existing laws. Additional law and regulation will not prevent unscrupulous people from being dishonest.

It is even more important to stress that additional registration requirements and more entrance level exams will not prevent the unscrupulous from becoming financial planners and will not ensure the continuing competence of those who are financial planners.

The Society believes that full disclosure is the most effective means to enable consumers to select competent counsel from among the many people offering financial planning services. Such disclosure requirements already exist in the state and federal securities laws and in many state insurance codes. These state insurance laws prohibit an insurance agent from using the term "financial planner" to imply that the agent receives compensation which is unrelated to sales unless such is actually the case. In keeping with this philosophy and with the investment adviser laws, we believe full disclosure is proper for all.

III. Summary of Position

The American Society takes the position that the appropriate response to the current consumer concern regarding the qualifications of financial planners is to rigorously enforce the existing state and federal investment adviser laws requiring registration, reporting, and disclosure. These laws should be interpreted to appy to anyone who provides advice with respect to a security as defined in the laws.

A. Federal Law

Most financial planners who provide investment advice are already subject to federal law under the Investment Advisers Act of 1940. Investment Advisers Release No. 1092, issued on October 8, 1987, extended the definition of "investment adviser" to include financial planners who provide securities advice as defined in the Act. The Society encourages all financial planners who meet the requirements of the Act to register as investment advisers.

B. State Law

The Society also supports the uniform state regulation of financial planners when they act as investment advisers under the 1986 amendments to the Uniform Securities Act of 1956 as proposed by the North American Securities Administrators Association (NASAA).

The Society does not support non-uniform state financial planner or investment adviser laws which would impose a patchwork of inconsistencies in reporting, disclosure, registration and licensure. The inevitable result will be an increase in consumer costs as the increased costs of doing business are passed on to the planner's clients. The Society does not support laws restricting the use of the term "financial planner."

The Society asserts that the proper method to protect consumers is to give them the facts for their own protection. Enforcement of the reporting and disclosure requirements of the federal and state investment adviser laws and an increasing awareness by consumers of the professional financial planning designations will allow consumers to select out the unqualified. Better knowledge of the industry professional and trade organizations which set high ethical and continuing educational standards will also aid in a consumer's selection of an adviser.

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Senator DODD. Well, thank you very much, all three of you. Looking as a panel of Irishmen, Carroll, Hughes, and Driskill, up here, it is unique, and I want to tell you this, obviously, there's some distinctions in your testimony, but to have a group of people come from the private sector to testify before a congressional committee about regulation, to one degree or another, is not something that happens every day to the Congress, and so it is a bit unique in that regard.

You have each made sort of different recommendations, a bit, anyway, about what needs to be done, and there are some similarities that run, obviously, between all three of you, although I would say, Mr. Driskill, in your—I suspect that Mr. Hughes and Mr. Carroll might take some exception with the idea that "financial planner" is a generic term as such.

What I would like to do here for just a couple of minutes, not to keep you too long, but to ask each one of you if you might comment on either the drawbacks you see in these recommendations or suggestions of your copanelists here as to how we ought to proceed.

Mr. Carroll, I will begin with you.

Mr. CARROLL. Sure.

Senator DODD. If you might comment on Mr. Driskill's comments and whether or not you think he goes far enough or not far enough in the notion of some sort of regulatory scheme.

POSSIBLE DRAWBACKS

Mr. CARROLL. Well, I think that if there were no problems in the marketplace at this point in time, we probably would not be sitting here today, and I think what he is saying is, everything is fine now, leave it alone. I think the mere fact that we are here probably is evidence that that may not be true.

With regard to Mr. Hughes' comments, I'll point out that I am a member of his organization; he's a member of my organization, so we are representing each other. I don't disagree with anything that Charlie said per se, but I do think that reality is that those enforcement-type things are already provided for in the law, and it is not taking place at this point, that there are some problems in the marketplace, and that somebody needs to own this thing to the extent of being accountable for going and getting it done. Somebody needs to own the financial planning industry and the regulation of that industry. And that is why we have reached the conclusion that we have.

I don't think that economic or political reality supports the others happening, certainly not in the near term. They may in the long term. The realities of solving the situations in the marketplace at this point, so that the consumer knows what to expect when they go to a financial planner will take more action at this point.

Senator DODD. Let me ask an additional question, which I will also pose, and I will stop and let you respond, as I have suggested.

You may have heard, and I think you did, because I saw you sitting here, talking to Mr. Meyer, and there have been these other studies done about professional organizations that sort of—putting it very bluntly—up the ante in terms of getting in, and it is a way

of keeping the numbers down of the providers of whatever that service may be, and that it, in fact, doesn't reduce the dishonesty of the fraud problems, that this is not—it doesn't keep it out. At least that has been the studies done in a number of areas of professions in the past.

I wonder if you might comment on that. I am inclined to agree with you. I am not arguing against it. I am just wondering what the answer is in this particular situation.

Mr. CARROLL. Well, I think if we up the ante, the most important thing that we have to do is to crystallize in the consumer's mind what a financial planner does, what his qualifications are and what those expectations should be if they go to a planner, what they are entitled to. By upping the ante, if that funds our ability to crystallize those fairly objective criteria, then I think it is something that would be acceptable.

If we up the ante and all it does is exclude some people at the lower end, and we still have not crystallized what a financial planner is, if we still have not identified that if you call yourself a financial planner, you do fall under this regulation as opposed to the situation now where a lot of planners do not fall under the regulation. The immediate examples that come to mind are financial planners within banks that may not be regulated in any way, shape or form, and the accountants that call themselves financial planners and in a lot of cases provide financial planning advice but are not regulated as financial planners.

Senator DODD. Mr. Hughes.

Mr. HUGHES. With regard to Larry's testimony in favor of perhaps carving financial planning out as a type of investment adviser, if we were starting this all over and there weren't investment advisers and financial planners, that would probably be an effective course of action, but we are not, and therefore, our general conclusion is, it is impractical to carve financial planners out as simply a type of investment advisers. And that is based in part on the fact that overwhelmingly when consumers engage a financial planner, they expect that individual to be capable to render investment advice. Whether the client's circumstances warrant investment advice or not is clearly dependent on the client's circumstances.

That fact is also the reason that the Institute would probably depart from Mr. Driskill's characterization of financial planning as a generic term. That may have been true 3, 4, 5, 6 years ago when financial planning was unfortunately used as a more palatable way to describe insurance salesmen, mutual fund salesmen or securities salesmen, but the public is growing to expect certain services from a financial planner, and if we don't assist them in this progress, they are going to go forward and identify them on their own behalf. We believe they have already made significant progress in that direction. Therefore, we believe that it is suitable to impose investment adviser regulation on those who describe themselves as financial planners, because members of the public expect the individual who so describes himself to be able to provide investment advice.

With regard to setting up a framework which could raise the ante, thereby discouraging those from entering the profession, we

are sensitive to that, not because those who are members of our organization have not pursued voluntary professional education—they all have—so at first glance we may want to be in favor of that, but we are not. We would prefer substituting exclusionary forms of regulation, and we view an SRO as basically exclusionary, by emphasizing with consumers, they have a right of choice. They can use an investment adviser/financial planner who has no educational background in that area, no previous experience, or through full disclosure, they can choose a financial planner who has an educational background, who has possibly professional certification and experience. The right of choice is the consumer's. Anything which would be exclusionary rather than inclusionary, we would not be in favor of.

Senator DODD. Mr. Driskill, back to you.

Mr. DRISKILL. Senator, first of all, in regard to Mr. Carroll's comments, we do feel that there are abuses, obviously, and there is fraud in the marketplace, and we feel that that abuse and fraud must be dealt with to protect the consumer. I think the place where we differ is the fact that we feel there are already adequate existing laws and regulations in place right now to protect that consumer without adding the additional burden of additional cost with new layers of regulation. What we are very much for is the rigorous enforcement of those laws and regulations that are there.

To this extent, I agree wholeheartedly with Mr. Hughes' testimony, that it is time to get off the dime and begin putting money into SEC enforcement or wherever else it needs to be placed, at the State level, to make sure that adequate enforcement is there.

Senator DODD. How about the fees? I am not telling you anything all three of you don't know. I mean whether you elect Michael Dukakis or you elect George Bush, we all sitting here know darn well that come next January, we are still going to be in a worse situation in terms of getting money for things. You know, that is going to be tough. I appreciate what you are saying, but—it's difficult. What about fees? What about increasing some of them? One of you mentioned, I think maybe Mr. Carroll, I'm not sure, talked about higher fees—maybe it was Mr. Hughes. I don't know—for bigger firms or whatever, but as a way of raising some of that.

How would you feel about that?

RAISING FEES

Mr. DRISKILL. In deference to Mr. Ruder's testimony I would say I would be very much in favor of seeing fees to investment advisers increased, if those fees could be generally channeled into enforcement for rigorous enforcement of those regulations that are there. I would be very much for that.

Senator DODD. Mr. Carroll.

Mr. CARROLL. The current fee, as you know, is $150. To any competent planner with a functioning firm, the difference between $150 and $1,000 is nonexistent. I mean, the $850 isn't going to hurt anybody that much, if that is directed to the enforcement of the industry.

Senator DODD. Yes. The problem with it, and you may have heard me say this as well, I agree with you, this becomes then the

way in which you start doing these things all down the road. But anyway, it is one that certainly deserves examination, because we are in this tough bind, and obviously, under anyone's scenario, obviously, if you are going to have these laws and can enforce them, then it is a hoax.

I can't tell you how helpful you have been, all three of you, and it has been a good learning experience, this process. Again, I don't—we are going to sit down and examine how we ought to proceed from this particular point, but there are some similarities and some common ground emerging, which I think is tremendously helpful. And so we would like to stay in touch with you during this process. You are the ones in the industry.

And again it needs to be said, and I don't know if I said it as loudly or as clearly as I could have at the outset, like everything else, whether it is 14,000 or 200,000, most people in this business, whether they be investment advisers or financial planners or something in between, are honest, reputable people who try and serve their clients and their customers and consumers well.

But if that were the way of the world in every other area, we wouldn't need any laws at all. Unfortunately, we are seeing, as you all point out, an increase in the number of abuses and fraud because of the explosion in the industry, and that is going to happen.

So the question is, how do we best address that in an intelligent, thoughtful way, which makes it possible for people who have chosen that line of profession to continue to function in it without being hog-tied and crippled in the process and simultaneously guarantee that those consumers and individuals can go to that person who holds himself out as an investment adviser or financial planner—and someone said it, I think it is worthwhile—all of us in this room understand the distinction. I'll guarantee you, there isn't a fraction of 1 percent of the American public that think there is the slightest bit of distinction between those two definitions of those two names—investment adviser and financial planner—and how we guarantee that that individual, to the extent possible, can rely upon that individual or that firm to maintain the fiduciary relationship with life savings and earnings, and so forth.

That's the balance. It shouldn't be that difficult, if we think about it and proceed carefully.

So again I appreciate all three of you coming here this morning and the rest of our witnesses who were here.

And on that note, this subcommittee will stand adjourned.

[Whereupon at 1 p.m., the hearing was adjourned.]

APPENDIX A

COURSEWORK OFFERED BY THE AMERICAN COLLEGE

There are two tracks leading to the CLU designation. The personal insurance specialty is designed for those whose principle interests are personal property and casualty insurance. The life insurance specialty has its primary focus on life and health insurance.

Chartered Life Underwriter (Life Insurance)

Required
- Individual Insurance
- Life Insurance Law
- Group Benefits
- Intro to Financial Planning
- Income Taxation
- Investments

Elective
- The Financial System in the Economy
- Pensions and Other Retirement Plans
- Estate Planning I
- Estate Planning II
- Planning for Business Owners and Professionals

Chartered Life Underwriter (Personal Insurance)

Required
- Personal Risk Management I
- Personal Risk Management II
- Multiline Insurance Law
- Intro to Financial Planning
- Income Taxation
- Investments

Elective
- The Financial System in the Economy
- Pensions and other Retirement Plans
- Estate Planning I
- Estate Planning II
- Planning for Business Owners and Professionals
- Group Benefits

Chartered Financial Consultant (ChFC)

Required
- Intro to Financial Planning
- Income Taxation
- Individual Insurance
- Investments
- Estate Planning I
- Financial Planning Applications

Elective
- The Financial System in the Economy
- Employee Benefits
- Wealth Accumulation Planning
- Planning for Business Owners and Professionals
- Business Taxation and Planning

T149B/CORAF